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Level-Playing Field: The Regulatory Framework for  
Islamic Banks in the United Kingdom and Malaysia

BY

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Thesis submitted for the degree of PhD

2016

Department / Centre of Financial and Management Studies  
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A handwritten signature in black ink, appearing to read 'Nuramarina Zolkapli', with a stylized 'v' above the 'u'.

Nuramarina Zolkapli

Date: 17 December 2016

## **DEDICATION**

Firstly, I would like to express my sincere gratitude to both of my supervisors, Professor Laurence Harris and Dr. Jonathan Ercanbrack for their continuous support of my PhD study and this research, for their patience, motivation, time, and immense knowledge. I could not have imagined having better supervisors than both of them. Besides that, I would also like to thank Professor Ciaran Driver for being a supportive PhD tutor throughout the past four years.

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## **ABSTRACT**

'Level-playing field' is an expression used by regulators in expressing the fair treatment of financial institutions. 'Level-playing field regulations' is also a representation of benchmark-setting in response to the complexity and diversity that exists in the financial system. Nonetheless, such a notion has never been precisely defined thereby bringing into question the usefulness of this idea. Therefore, the aim of this research is to examine the concept of level-playing field regulations.

In particular, this research investigates level-playing field regulations for retail Islamic banks in the United Kingdom and Malaysia - two notable examples where level-playing field has been expressed in regulatory reforms. A comparative law methodology is employed, and a criterion judging whether there is (i) 'equality before the law'; and (ii) 'a fair opportunity to compete' is established to test whether a level-playing field exists. This research is the first to determine the extent to which retail Islamic banks can be considered to be operating within a level-playing field.

One of the significant findings from this study is that the regulators in the UK and Malaysia have not fully enabled level-playing field regulations for retail Islamic banks. It is also inferred that due to the complexity of the financial system, exposure to risks and the nature of law, the regulatory environment for the banking system does not allow the level-playing field regulations to be effective. Therefore, level-playing field regulation is not a useful concept.

By challenging the existing regulatory framework, this research provides pivotal insights to regulators and scholars on the criterion, challenges and impact of level-playing field regulations. This research will encourage the reconsideration of using this concept.

## ABBREVIATIONS

BOE	Bank of England
DGDS	Deposit Guarantee Directive Scheme
EU	European Union
FCA	Financial Conduct Authority
FPC	Financial Policy Committee
FSA	Financial Services Act
MDIC	Malaysian Deposit Insurance Scheme
PLS	Profit and Loss Sharing
PRA	Prudential Regulatory Authority
PSR	Profit Stabilisation Reserve
SDLT	Stamp Duty Land Tax
IAH	Investment Account Holder
CIS	Collective Investment Scheme
FSMA 2000	Financial Services and Markets Act 2000
SPV	Special Purpose Vehicle
AFIB	Alternative Finance Investment Bond
RAO	Regulated Activities Order
UKLA	United Kingdom Listing Authority
HPP	Home Purchase Plan
SSB	Sharia Supervisory Board
AAOIFI	Accounting and Auditing for Islamic Financial Institutions
IFSB	Islamic Financial Services Board
HQLA	High Quality Liquid Assets
EBA	European Banking Commission
LCR	Liquidity Coverage Ratio
BIS	Bank of International Settlements
FA	Finance Act
VAT	Value-Added Tax
BBA	Bai Bithaman Ajil
CEO	Chief Executive Officer
NSAC	National Sharia Advisory Council
CBA 2009	Central Bank Act 2009
SAC	Sharia Advisory Council
FSA 2013	Financial Services Act 2013
IFSA 2013	Islamic Financial Services Act 2013
ICM	Islamic Capital Market
MIFC	Malaysia International Islamic Financial Centre
IBFIM	Islamic Banking and Finance Malaysia
INCEIF	International Centre for Education in Islamic Finance
ISRA	International Sharia Research Academy for Islamic Finance
IILM	International Islamic Liquidity Management Corporation
IBA 1983	Islamic Banking Act 1983
LFX	Labuan Financial Exchange
Bursa-Mal	Bursa Malaysia
IRB	Inland Revenue Board
SC	Securities Commission of Malaysia

LFSA	Labuan Financial Services Authority
IFIs	Islamic banking and financial institutions
BIMB	Bank Islam Malaysia Berhad
FC	Federal Constitution
BNM	Bank Negara Malaysia
IIMM	Islamic Inter-bank Money Market
GIC	Government Investment Certificate
CBM	Central Bank of Malaysia
IBS	Islamic Banking Scheme
MII	Mudaraba Interbank Instruments
NIID	Negotiable Islamic Instruments of Deposit
MOF	Ministry of Finance
IRB	Inland Revenue Board
YA	Year of Assessment
ITA 1967	Income Tax Act 1967
RPGT 1976	Real Property Gains Tax Act 1976
RPGT	Real Property Gains Tax
SD 1949	Stamp Duty Act 1949
DM HPP	Diminishing Musharaka Home Purchase Plan
DM	Diminishing Musharaka
HMRC	Her Majesty Revenue and Customs
UNCITRAL	United Nations Commission on International Trade Law
KLRC	Kuala Lumpur Regional Centre for Arbitration
AALCO	Asian-African Legal Consultative Organisation
DIAC	Dubai International Arbitration Centre
ADCCAC	Abu Dhabi Commercial, Conciliation and Arbitration Centre
IICRCA	International Islamic Centre for Reconciliation and Commercial Arbitration



## **GLOSSARY\***

Commodity Murabaha	A Murabaha purchase and sale transaction of Sharia compliant commodities, whereby the buyer purchases the commodities on a deferred payment basis and subsequently sells them to a third party on a cash payment basis.
Diminishing Musharaka	Diminishing Musharaka is a form of partnership in which one of the partners (customer) promises to buy the equity share of the other partner (financier) gradually until the title to the equity is completely transferred to the buying partner. The transaction starts with the formation of a partnership, followed by the financier leasing his equity share to the customer throughout the tenure of the lease, the customer will gradually buy the other financier's share at market value or the price agreed upon at the time of entering into the contract. The "buying and selling" contract is independent from the partnership contract and should not be stipulated in the partnership contract since the buying partner is only allowed to give only a promise to buy. It is also not permitted that one contract be entered into as a condition for concluding the other.
Fatwa	A juristic opinion or pronouncement of facts given by the Sharia board, a mufti, or a faqih (scholar) on any matter

	pertinent to Sharia issues, based on the appropriate methodology.
Ijara	An Ijara contract refers to an agreement made by an institution offering Islamic financial services to lease to a customer an asset specified by the customer for an agreed period against specified instalments of lease rental. An Ijara contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the Ijara contract.
Ijara Muntahia Bittamlik	An Ijara Muntahia Bittamlik (or Ijara wa Iqtina) is a form of lease contract that offers the lessee an option to own the asset at the end of the lease period either by purchase of the asset through a token consideration or payment of the market value, or by means of a gift contract.
Islamic window	Islamic window is part of a conventional financial institution (which may be a branch or a dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are Sharia compliant.
Muḍaraba	A Muḍaraba is a contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity, which is to be managed, by the entrepreneur as the Muḍarib (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the Muḍaraba agreement whilst losses are to borne solely by the capital

	provider unless the losses are due to the Muḍarib's misconduct, negligence or breach of contracted terms.
Murabaha	A Murabaha contract refers to a sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in their possession at cost plus an agreed profit margin (selling price).
Musharaka	A Musharaka is a contract between the institution offering Islamic financial services and a customer to contribute capital to an enterprise, whether existing or new, or to own a real estate or moveable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of Musharaka agreement whilst losses are shared in proportion to each partner's share of capital.
Salam	A Salam contract refers to an agreement to purchase, at a pre-determined price, a specified kind of commodity not available with the seller, which is to be delivered on a specified future date in a specified quantity and quality. The institution offering Islamic financial services, as the buyer, makes full payment of the purchase price upon execution of a Salam contract. The commodity may or may not be traded over the counter or on an exchange.
Sharia	Divine Islamic law that encompasses all aspects of human life as revealed in the Quran and the Sunnah.

Sharia supervisory board	A specific body set up or engaged by the institution offering Islamic financial services to supervise its Sharia compliance and governance system.
Sukuk (sing. Sakk)	Sukuk (certificates) each of which represents the holder's proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such an asset.
Takaful	Takaful is derived from an Arabic word which means solidarity, whereby a group of participants agree among themselves to support one another jointly against a specified loss. In a Takaful arrangement, the participants contribute a sum of money as tabarru' (donation) into a common fund, which will be used for mutual assistance of the members against specified loss or damage.
Urbun	Urbun is earnest money held as collateral (taken from a purchaser or lessee) to guarantee contract performance after a contract is established.
Wadiah	An amount deposited whereby the depositor is guaranteed his/her fund in full.
Wakala	An agency contract where the customer (principal) appoints the institution offering Islamic financial services as an agent (wakil) to carry out business on their behalf.
Istisna'	An Istisna' contract refers to an agreement to sell to a customer a non-existent asset, which is to be manufactured or built according to the buyer's specifications and is to be

	delivered on a specified future date at a predetermined selling price.
Parallel Istisna'	A parallel contract where the institution offering Islamic financial services (IIFS) depends on another party (for example, manufacturer/developer) to manufacture a specified asset, which corresponds to an existing Istisna' contract between the IIFS and a customer. However, both contracts are independent of each other.
Tawarruq	A person who buys a commodity at a deferred price, in order to sell it in cash at a lower price. Usually, the sale is to a third party, with the aim to obtain cash. <sup>1</sup>

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\* The definitions provided in this Glossary are borrowed directly from the list of terminologies and definitions provided by the Islamic Financial Services Board (IFSB) via <<http://www.ifsb.org/terminologies.php> > accessed: 19 August 2015

<sup>1</sup> Tawarruq definition, via <[http://www.islamic-banking.com/glossary\\_t.aspx](http://www.islamic-banking.com/glossary_t.aspx)> accessed 28 August 2015

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Financial Services Act 2013

Financial Services and Markets Act 2000

Financial Services and Markets Act 2000 (Regulated Activities Order) 2001

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Order 2006

VAT Act 1994

## **STATUTES AND STATUTORY INSTRUMENTS (MALAYSIA)**

Central Bank Act 2009

Central Bank of Malaysia Act 2009

Companies Act 2006

Corporation Tax Act 2009

Federal Constitution of Malaysia (as at 2007)

Islamic Banking Act 1983

Islamic Financial Services Act 2013

Malaysia Deposit Insurance Corporation Act 2011

## **STATUTES AND STATUTORY INSTRUMENTS (EUROPEAN / GLOBAL)**

Rome Convention on the Law Applicable to Contractual Obligations 1980

Basel Committee on Banking Supervision (BCBS) Charter

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## **CHAPTER ONE: INTRODUCTION**

### **1.0 (a) THE DEVELOPMENT OF ISLAMIC FINANCE IN THE UNITED KINGDOM AND MALAYSIA**

### **(b) THE DEVELOPMENT OF ISLAMIC FINANCE IN MALAYSIA**

### **1.1 RATIONALE AND MOTIVATION**

### **1.2 OBJECTIVE**

### **1.3 THE SCOPE OF THIS RESEARCH**

### **1.4 TERMINOLOGY**

### **1.5 GENERAL METHODOLOGY**

#### **1.5.1 COMPARATIVE LAW**

#### **1.5.2 LEVEL-PLAYING FIELD REGULATIONS TEST**

### **1.6 SCHOLARLY CONTEXT**

### **1.7 RESEARCH STRUCTURE**

In recent years, bank regulators have been struggling to design an appropriate framework for banking regulations. Banks have the potential to create substantial negative externalities by reducing the money supply, especially because the banking system is prone to contagion effects when failures occur.<sup>2</sup> As a result, the fear of a banking crisis is a key consideration for banking regulators. As a consequence, bank regulators must regularly monitor and re-evaluate banking regulations in order to safeguard bank deposits held by the public. In addition, banking regulators are required to ensure that the impact of existing bank regulations is appropriate and adequate to the needs of the prevailing financial environment.

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<sup>2</sup> Ethan B. Kapstein, *Governing the Global Economy*, (1994), p.18

With the constant changes and evolution in the financial markets environment, the regulatory frameworks governing the banking and financial services institutions, nationally and internationally, are expected to be able to accommodate the existing and the future financial markets. The banking and financial regulation should not remain static, so as to become outdated and ill-equipped. Therefore, there is a constant pressure and challenge for the regulators to provide the most suitable regulation in meeting the needs of a complex, diverse, competitive, as well as fragile financial system. Failure to provide an appropriate regulatory framework ultimately exposes financial markets to negative externalities that can lead to severe financial crises.

Aware of the complex and diverse nature of the financial system, international and national banking regulators have made vast efforts to stabilise and standardise the fragile financial system. In light of this, the metaphor of Level-Playing Field regulations has been used as a benchmark of uniformity for regulatory standards; representing the regulators' fair treatment for all banks and financial institutions. For instance, international agreements such as Basel Accords incorporate the concept of level-playing field regulations so that banks can remain competitive. Therefore, the role of Basel Accords, as an international standards setter, is to strengthen the capital position of banks in a manner consistent with a level financial playing field.<sup>3</sup> In another example, the rise of the Islamic banking sector has also seen the creation of an international standards setter for Islamic finance, namely the Islamic Financial Services Board (IFSB), which provides international regulatory standards in order to level the playing field for Islamic banks in financial services sector dominated by

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<sup>3</sup> Ibid., p.105. See, Basel Committee on Banking Supervision (BCBS) Charter, Article 2

conventional banks.<sup>4</sup> Similarly, national regulators have used the concept of level-playing field regulations when treating all the banking institutions operating in their jurisdiction within their own regulatory architecture.

Throughout the past decade, there have been various regulatory changes in the banking sector (which is rather a series of experimental reforms) to accommodate the growing complexities in the financial system.<sup>5</sup> Several factors have been identified as an influence to the phenomena of this increasing complexity within the financial system. These factors include: innovation of financial products offerings, differences in market size, information technology, political-cultural-historical backgrounds, differences in regulatory approaches, the establishment of various types of banking and financial institutions, as well as the globalisation of banking and financial system.

Banking regulators and policy makers have always encouraged financial innovation and competition among market players.<sup>6</sup> As such, the banking and financial system continues to evolve as a result of the latest financial innovations and competition. One notable example of financial innovation in the market place is Islamic finance. Islamic financial products, which are distinct in nature from conventional financial products, have achieved notable growth. For example, since its beginning in 1975, Islamic finance is reported to have reached USD1.87 trillion in financial assets in less than 40

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<sup>4</sup> Islamic Financial Services Board (IFSB) Annual Report 2015

<sup>5</sup> Howell E. Jackson, 'Centralization, Competition, and Privatization in Financial Regulation,' (2001), p.656

<sup>6</sup> See, 'The Digital Tipping Point: Banks Must Focus on Innovation to Harness Opportunities and Address A New Generation of Competitors' via <<https://www.bba.org.uk/>> accessed: 23 July 2015, 'The FCA and Innovation' via <<https://www.fca.org.uk/news/the-fca-and-innovation>> accessed 28 July 2015

years.<sup>7</sup> Islamic banking has contributed heavily to this growth, almost doubling in size (measured by banking assets) in recent years – from USD417 billion in 2009 to USD778 billion in 2013<sup>8</sup>. The significant growth of Islamic finance in the financial system has merited a response from banking and financial regulators across jurisdictions to develop regulatory accommodation for Islamic banks. In a short space of time, Islamic finance has become an important market player in various jurisdictions. Islamic banking, for example, comprises almost half of the total banking sector in Saudi Arabia (49%) and Kuwait (45%)<sup>9</sup>. As a result, banking and financial regulators have become more receptive to the specific risks attached to Islamic banks in terms of their products and institutional operations as well as their impact on the stability and resilience of the financial system.<sup>10</sup> Therefore, in some jurisdictions, regulatory reforms have been made to accommodate Islamic finance and, moreover, in jurisdictions where the Islamic financial sector has had a significant impact, there have been examples of large-scale revisions of the national regulatory architecture (This has occurred mostly in countries with a Muslim-majority population, while in most secular countries, regulatory reforms are made from time to time within the conventional financial regulatory framework).<sup>11</sup>

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<sup>7</sup> Supra, Note. 3. There is no empirical evidence to show the comparative total assets between Islamic and the conventional sector. However, the source from the UK Business Insider shows that the total global financial assets are reported to be at USD 294 trillion as at 2013. See, Business Insider, <<http://uk.businessinsider.com/global-financial-assets-2015-2?r=US&IR=T>> accessed: 15 July 2015

<sup>8</sup> EY (2014) World Islamic Banking Competitiveness Report 2014-15, EY, Bahrain: Manama, p.14

<sup>9</sup> Ibid.

<sup>10</sup> Supra, Note. 3, p.4

<sup>11</sup> Global Islamic Finance Report 2011

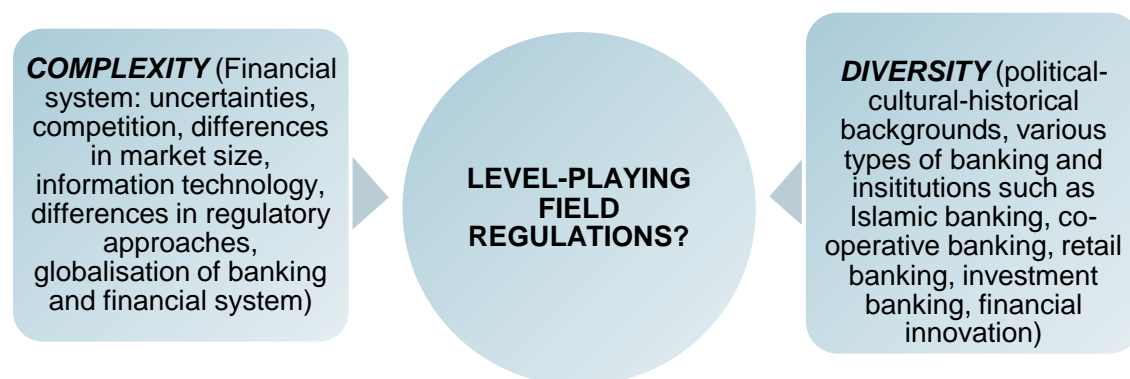


The creation of specific regulatory accommodations for Islamic financial products or the sector as a whole demonstrates that banking regulators have acknowledged the sector's significance as well as appreciating how the risks related to Islamic banks affects the stability of the financial system. The innovation of Islamic financial products can also be observed as a contributing factor to a more diverse financial system. This has therefore added to the complexity and uncertainty which already exists in the financial system; and this ultimately increases the challenge for banking regulators to develop appropriate regulatory standards.

As mentioned earlier, the level-playing field regulation which has been used as a concept by global and national banking regulators represents the concept of fairness. It is used as a metaphoric term to represent the standardisation of rules that are believed to be functional within the complex and diverse financial system. The international agreements such as the Basel Accords which aim to provide level-playing field regulations for all banks, in fact, do not consider the nature of the Islamic banking sector, hence IFSB Guidelines were established to compliment the lack of level-playing field regulations in Basel Accords. Therefore, arguably, the level-playing field regulations which are created by longstanding global banking regulators such as the Basel Committee have not fully enabled the concept of level-playing field regulations.

Scenarios such as these have therefore raised the question of the extent to which the level-playing field regulations have been usefully applied into the complex financial system whilst simultaneously enabling the regulators to encourage financial innovation and competition. In other words, are regulators able to reconcile the existing forces

that exist in the financial system and the level-playing field regulations as well as encouraging financial diversity. This can be illustrated in the following diagram:



Source: Author's own

This scenario has therefore led this research to investigate the level-playing field regulations, by giving specific reference to Islamic banks. The countries in focus are the United Kingdom (the UK) and Malaysia.

### **(a) The development of Islamic finance in the United Kingdom**

The Islamic banking sector in the UK has been continuously develop since its first product were made available in the UK market where the first retail product is reported to have reached its consumers in the 1990s when the Gulf Cooperation Council introduced Islamic mortgages through Murabaha and Ijara transactions.<sup>12</sup> Nevertheless, investment products have in fact reached the Middle Eastern private investors earlier, where in the year 1980s the commodity Murabaha transactions were

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<sup>12</sup> The CityUK, 'The UK: The Leading Western Centre for Islamic Finance', (November 2015)

introduced by Al Baraka International Bank. During these periods, the Islamic banking products were consumed by the Middle Eastern customers and not until recently, the Islamic banking products are also consumed by the locals consisting of Muslims and non- Muslims.<sup>13</sup>

The Islamic banking sector continues to offer its products in the UK market where the latest report has revealed that at least 20 Islamic financial institutions are operating in the UK and five of them are fully Sharia-compliant.<sup>14</sup> With the existing numbers of Islamic banks operating in the UK, it has also been reported that the country is now accommodating the largest number of Islamic banks in comparison with any other Western countries.<sup>15</sup> In 2004, the first Sharia-compliant bank in the UK was the Islamic Bank of Britain (IBB),<sup>16</sup> which is now rebranded as Al Rayan Bank (hereinafter referred to as Al Rayan<sup>17</sup>), followed by the the Bank of London and the Middle East (2007), Gatehouse Bank (2008), Qatar Investment Bank (UK) (2008) and Abu Dhabi Islamic Bank (2013)<sup>18</sup>. In 2012, seventeen 'Islamic windows' were established by the

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<sup>13</sup> See, Michael Ainley, Ali Mashayeki, Robert Hicks, Arshadur Rahman, and Ali Ravalia., 'Islamic Finance', (2007), p.6

<sup>14</sup> See, Michael Ainley, Ali Mashayeki, Robert Hicks, Arshadur Rahman, and Ali Ravalia., 'Islamic Finance', (2007), p.10, Report: The CityUK, 'Islamic Finance' (2012), p. 3 and Report: Global Islamic Finance Report (2012). Sharia-compliant technically means the adherence to Islamic principles. More explanation can be found in the terminology section.

<sup>15</sup> Supra, Note 12. The number of Islamic financial institutions in other Western countries such as the United States of America (10), Australia and Switzerland (4) and France (3).

<sup>16</sup> Michael Ainley, Ali Mashayeki, Robert Hicks, Arshadur Rahman, and Ali Ravalia., 'Islamic Finance', (2007), p.10, Report: The CityUK, 'Islamic Finance' (2012), p.6

<sup>17</sup> The change of name took place in December 2014 following the acquisition by Masraf Al Rayan QSC (MAR) via <<http://www.alrayanbank.co.uk/>>accessed 19 April 2015

<sup>18</sup> United Kingdom Trade & Investment, 'UK Excellence in Islamic Finance', (2014) via <<https://www.gov.uk/government/>> accessed 6 August 2015

conventional banks.<sup>19</sup> Notably, the Islamic banking sector has collected USD 3.6 billion worth of assets as at the end of the year 2014.<sup>20</sup>

While the figures are seen as promising, it has also been observed that the number of Islamic banking windows in operation has decreased. For example, in 2012, HSBC terminated its 'Islamic window' operation (HSBC Amanah) in most countries including the UK, except for Malaysia and Saudi Arabia. It is reported that the termination was due to their worldwide strategic review, which included a decision to restructure their Islamic banking business.<sup>21</sup> These facts have therefore shown that there is a mixed demand of the Islamic banking sector in the UK, on the one hand, the number of Islamic banks and market remains the leader among the Western world, on the other hand the termination of Islamic window operation in the UK has shown that the demand for Islamic banking does not always exist.

In terms of the Sukuk market, London is the international centre for Sukuk issuance. The UK is reported to be the first Western country to issue a sovereign Sukuk worth £2.3 billion.<sup>22</sup> To date, the total of 57 Sukuk have been listed on London Stock Exchange with the total value of USD51 billion.

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<sup>19</sup> Supra, Note. 9. Islamic windows banks in the UK includes : ABC International Bank Ahli United Bank Bank of Ireland Barclays BNP Paribas Bristol & West Citi Group Deutsche Bank Europe Arab Bank HSBC Amanah IJB International London J Aron & Co. Lloyds Banking Group Royal Bank of Scotland Standard Chartered UBS United National Bank. See, Report: TheCityUK, 'Islamic Finance', (2012), p.4

<sup>20</sup> The CityUK, 'The UK: The Leading Western Centre for Islamic Finance', (November 2015)

<sup>21</sup> HSBC Amanah via <<http://www.hsbcamanah.com/>>, and NewHorizon Magazine (Issue : Oct – Dec 2012), p.6 via <<http://www.islamic-banking.com/>> accessed: 10 September 2014

<sup>22</sup> The CityUK, 'The UK: The Leading Western Centre for Islamic Finance', (November 2015)

With regards to the market size of Islamic financial sector in the UK, there is no available data which shows the exact figure of the sector performance. However, a report has revealed that the market size of the Islamic financial sector globally only represents 1% of the global banking assets.<sup>23</sup> GCC countries and MENA countries are leading the Islamic financial sector at the global level with 38 per cent and 35 per cent respectively, whereas the UK categorised together with other countries totalled the market size for only 4.8 per cent.<sup>24</sup> The latter figure, therefore, indicates that the market size of the Islamic financial sector is relatively small compared to any other regions.

#### **(b) The development of Islamic finance in Malaysia**

It has been reported that the first Islamic financial institution in Malaysia was formed in 1963 with the establishment of Tabung Haji (the Pilgrimage Fund), however, the formation of the latter was not meant to carry the retail banking business. Tabung Haji was established as an Islamic financial institution to assist the Muslims in raising their personal savings for pilgrimage activities. Only 20 years later that the first Islamic bank called Bank Islam Malaysia Berhad (BIMB) was established in 1983 and the second fully-fledged Islamic bank was established in 1999; namely Bank Muamalat Malaysia Berhad.<sup>25</sup> Since then, the Islamic financial services industry in Malaysia has continued to flourish and now numbers 16 fully-fledged Islamic banking and financial institutions (IFIs), 11 Islamic windows, four international IFIs, and 16 Takaful (Insurance)

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<sup>23</sup> Ibid.

<sup>24</sup> Ibid. Islamic financial market size in Asian region consists of 22% and Sub-Saharan Africa is 1%.

<sup>25</sup> Global Islamic Finance Report 2011, p.164

companies.<sup>26</sup> To date, the Islamic financial market in Malaysia consists of 74.9 per cent of the total Islamic finance market size).<sup>27</sup>

The rationale and motivation of this research are highlighted in the next section.

## 1.1 RATIONALE AND MOTIVATION

- **The growth of Islamic finance:** Islamic finance is an example of financial innovation which has grown rapidly in the global financial market and has made a significant impact to the evolution of the financial system. Regulatory authorities across borders have provided specific regulatory accommodation which is believed to be able to provide a level-playing field for Islamic banks. However, the extent to which the level-playing field regulations for Islamic banks have been enabled by regulators is questionable.
- **Unique financial system risks:** The nature of Islamic finance is rather unique thus Islamic banks are exposed to some risks which are different in dimension than the risks to which conventional banks are exposed. This raises the question of how can regulators devise level-playing field regulations to accommodate the risks exposed to Islamic banks.

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<sup>26</sup> 'Malaysia's Islamic Finance Marketplace', (2013) via <<http://www.mifc.com/index>> accessed: 10 October 2013 and *EY Global Takaful Insights*, (2013), p.62

<sup>27</sup> The CityUK, 'The UK: The Leading Western Centre for Islamic Finance', (November 2015)

- **Comparative study:** The choice of the UK and Malaysia as comparative study is based on two main factors. Firstly, the same legal approach is practiced by both countries – that is, the common law system. In spite of this, a different angle of the level-playing field regulations for Islamic banks in the UK and Malaysia is applied. In the UK, the approach to level-playing field regulations for Islamic banks in their regulatory accommodation is within the conventional regulatory framework. Whereas in Malaysia, a dual-regulatory framework is established to represent the level-playing field regulations for Islamic banks. This comparative study is therefore essential where it highlights two countries with the same legal system and idea of treating Islamic banks on a level-playing field, with differing approach and interpretation. Hence, the research questions and analyses the extent to which the two common law countries have enabled the level-playing field regulations for Islamic banks in their respective jurisdictions.

Secondly, while both countries have undergone a different emergence of the Islamic financial sector, this comparative study is important noting the similarity of the fact that both countries' mission are to become the global hub for Islamic finance sector. Notably, the UK being one of the leading financial centres in the world has undergone a later development trajectory of Islamic finance in comparison to Malaysia. Retail Islamic products in the UK only began to reach the consumers in 1990s from the South East Asian banks and Middle Eastern banks while the first Islamic retail bank in Malaysia has started its operation in

the year 1983.<sup>28</sup> Additionally, there is the difference in market size of the Islamic financial sector in both countries (Islamic finance in the UK – 4.8 per cent of the total Islamic finance market size and Islamic finance in Malaysia – 74.9 per cent of the total Islamic finance market size).<sup>29</sup> However, a common factor is established with the fact that the growth of the Islamic financial sector in the UK and Malaysia has evolved rapidly - making both of the countries of different economic scale to be one of the leading Islamic financial hubs in the world (the UK for the Western countries and Malaysia for the South East Asian countries). Their success, albeit the existing differences (Islamic finance arrival in both countries and its market size), makes this comparative study as significant. In particular, this study examines the approach taken by the regulators of the two successful common law countries for the regulatory accommodation of retail Islamic banks.

- **Managing complexity and diversity:** Banking regulators have been encouraging financial innovation and competition in their financial systems which have resulted in diversity and complexity in the global financial system. However, the question arises as to how the regulators have enabled the level-playing field regulations where the nature of Islamic banks is different than the nature of conventional banks.

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<sup>28</sup> Michael Ainley, Ali Mashayeki, Robert Hicks, Arshadur Rahman and Ali Ravalia, 'Islamic Finance in the UK: Regulation and Challenges', (2007), p. 6

<sup>29</sup> The CityUK, 'The UK: The Leading Western Centre for Islamic Finance', (November 2015) (n.27)



- **‘Level-Playing Field’ regulations:** To the best of my knowledge, there is an absence of in-depth research on the level-playing field regulations for Islamic banks. For example, the elements that can be said to constitute ‘level-playing field regulations’. Also, there is no defined parameter as to what level-playing field regulations could mean with regards to Islamic banks and whether the regulators can enable the level-playing field regulations for Islamic banks. Therefore, an investigation on this subject can highlight whether the level-playing field regulations are a useful concept and whether there is a need of more banking regulations for Islamic banks in terms of a separate regulatory framework. This research builds up a theory of the level-playing field regulations and analyses the regulatory framework governing Islamic banks in the UK and Malaysia from the context of level-playing field regulations.

## 1.2 OBJECTIVE

In light of the issues discussed earlier, the principal objective of this thesis is to examine the level-playing field regulations governing Islamic banks in the UK and Malaysia by using the methods as set out in Section 1.5.

The principal research question raises three general subsidiary questions. Firstly, the extent to which the regulatory accommodation governing Islamic banks in the UK and Malaysia reflects with the notion of level-playing field regulations. In this regard, two test questions are used to analyse the principal question (see, Section 1.5.2). This research seeks to explore the areas through which the level-playing field regulations for Islamic banks expose the latter to any specific risk.

In turn, the second subsidiary question is to examine whether the level-playing field regulations for Islamic banks is indeed a useful concept. As highlighted in the introductory section, the uncertainties and complexities in the existing financial system has led the global and domestic regulators to establish benchmark regulations which serve to create a level-playing field for the banking and the financial services institutions. Meanwhile, the regulators have also been promoting market competitiveness and financial innovation. Therefore, this research seeks to analyse the extent to which the regulators reconcile the level-playing field regulations with the complexities and uncertainties that exist in the financial system. In light of these, the third subsidiary question is to examine the need of more banking regulations for Islamic banks for a better level-playing field.

### **1.3 THE SCOPE OF THIS RESEARCH**

This research focuses on the regulations governing Islamic retail banks which typically involves deposit-taking business involving private depositors, (as opposed to wholesale banks which involve corporates and governments as clients) and small financings.<sup>30</sup>

When referring to the level-playing field regulations, the context of regulation referred to involves the aspect of prudential regulation. Prudential regulation is a significant feature within the topic of banking regulations. Its role is to deal with the safety and soundness of financial institutions in order to protect depositors, regardless of the bank's impact on the economy.<sup>31</sup> Prudential regulation helps to protect depositors who

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<sup>30</sup> Shelagh Heffernan, *Modern Banking in Theory and Practice*, (1996), p.24

<sup>31</sup> Charles E. Goodhart, et al, *Financial Regulation: Why, How and Where Now?*, (1999), p.5.

often have very little information on the nature of the firm's business and therefore they are not in the best position to judge the safety and soundness of financial institutions. Moreover, due to the fact that banks are exposed to various types of risks, an appropriate prudential regulation for banks is crucial to maintain the stability of the financial system.

While this research mainly focuses on the aspect of retail banking, note that in the later chapters (Chapter 3 and 4), the discussion on Sukuk (commonly known as Islamic bond) and taxation is discussed. This is because, Sukuk is used by retail Islamic banks for their liquidity management and taxation supports retail Islamic mortgage product. Therefore, it is felt that such discussion is important to highlight the context of level-playing field regulations for Islamic banks.

#### **1.4 TERMINOLOGY**

This section describes terminology that is used throughout this research.

##### ***The United Kingdom and the English common law***

The United Kingdom of Great Britain and Northern Ireland comprises of three separate legal systems – England and Wales, Scotland, and Northern Ireland.<sup>32</sup> The English law refers to the law of England and Wales as they share the same legal system – the common law.

The UK has no codified constitution, and its constitutional arrangements are derived from various sources of law – (i) the legislation (which is produced through the

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<sup>32</sup> J. M. Smith (ed), "England and Wales" in *Elgar Encyclopedia of Comparative Law*, (2006), p.242

parliamentary system), (ii) delegated legislation (such as Orders in Council, statutory instruments, bylaws, regulations), (iii) case law, (iv) custom and (v) law reform (decided by the Royal Commission or the Law Commission).<sup>33</sup> The UK legal system upholds the notion of parliamentary supremacy which means that the constitutionality of primary legislation shall not be questioned by the English courts. However subsidiary legislation may be declared *ultra vires*.<sup>34</sup>

### ***The UK's regulatory framework***

The UK's regulatory framework refers to the regulatory governance by the Bank of England (BOE), Financial Policy Committee (FPC), Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA).

The PRA is a new subsidiary of the Bank of England, replacing the former Financial Services Authority (FSA). The PRA is responsible for prudential regulation of all deposit-taking institutions, insurers and investment banks. Its general objectives are “to ensure that the business of the firms it regulates is carried on in a way which avoids any adverse effect on the stability of the UK financial system”<sup>35</sup> and “to minimise the adverse effect that the failure of one of the firms it regulates could be expected to have on the stability of the UK financial system.”<sup>36</sup>

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<sup>33</sup> Ibid.

<sup>34</sup> Ibid. Ultra vires: “Beyond the powers. Term relating generally to the excess of legal powers or authority; specifically, the exercise by a corporation of powers beyond those conferred on it explicitly or implicitly.” See, L.B Curzon and P. H Richards (eds), *The Longman Dictionary of Law*, (2007), p.596

<sup>35</sup> Bank of England, ‘The Prudential Regulatory Approach to Banking Supervision’, (June 2014), p.8

<sup>36</sup> Ibid.

The FCA is the conduct regulator for PRA-authorised firms and prudential regulator for many other UK firms. Its general objectives are “to maintain and ensure the integrity of the market, regulate financial services firms to treat the consumers fairly and ensure the market’s competitiveness.”<sup>37</sup>

The BOE has the overall responsibility for financial stability in the UK and the FPC is primarily responsible for assisting the BOE to achieve its financial stability objective. Further, it is given the powers of recommendation and direction to the FCA and PRA to address systemic risk.<sup>38</sup>

The banking and financial services institutions in the UK are also subject to European Union law.<sup>39</sup> The governing legislation for the regulatory framework in the UK is the Financial Services Act 2012 and the legislation for financial services and markets is the Financial Services and Markets Act 2000.

Another terminology used to refer to the UK’s regulatory framework is ‘conventional regulatory framework’ whereby Islamic banks in the UK are governed alongside the conventional banks within the same regulatory framework (as opposed to the Malaysian regulatory framework where Islamic banks are governed separately). The terms ‘UK regulatory framework’ and the ‘conventional regulatory framework’ are used interchangeably.

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<sup>37</sup> ‘History of the Financial Conduct Authority’ via <<http://www.fca.org.uk/>> accessed: 13 July 2015

<sup>38</sup> Supra, Note. 35, p.5-6

<sup>39</sup> Ibid.

## ***Malaysia and the Malaysian Dual Regulatory Framework***

Similar to the UK legal system, Malaysia is a common law jurisdiction. However, unlike the UK which has no codified constitution, Malaysian constitutional governance is based on its written constitution which is called the Federal Constitution.

The financial services system in Malaysia is based on a dual regulatory framework.<sup>40</sup> It consists of a conventional or civil statute known as the Financial Services Act 2013 (FSA 2013) that governs the conventional banks including Islamic banking divisions (also known as 'Islamic windows').<sup>41</sup> Fully fledged Islamic banks are governed by the Islamic Financial Services Act 2013.<sup>42</sup> The FSA 2013 and IFSA 2013 do not supersede one another. Therefore, when referring to the term 'Malaysian regulatory framework', it implies a dual banking framework in which the Islamic financial sector and the conventional financial sector operate on a parallel footing.<sup>43</sup>

## ***Sharia and Sharia-compliance***

The usage of the term Sharia is rather broad, and it goes beyond its literal meaning. Sharia literally means "the road to the watering place, the path to be followed."<sup>44</sup> It is technically defined as "the Canon law of Islam, the totality of Allah's commands"<sup>45</sup> or otherwise regarded by Muslims as "matters which would not have been known but for the communications made to us by the Lawgiver".<sup>46</sup> This broad definition includes

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<sup>40</sup> Section 27 Central Bank of Malaysia Act 2009

<sup>41</sup> Section 15 Financial Services Act 2013

<sup>42</sup> Preamble, Islamic Financial Services Act 2013

<sup>43</sup> Section 27 Central Bank of Malaysia Act 2009

<sup>44</sup> M.H Khan, *The School of Islamic Jurisprudence* (1997), p.5

<sup>45</sup> Ibid.

<sup>46</sup> Nicolas P. Aghnides, *Mohammedan Theories of Finance* (1916), 23.

“revelations made by the Hebrew Prophets and Jesus,”<sup>47</sup> however a valid revelation in Islam is only complete and legitimate when such revelation is made through Prophet Muhammad (PBUH).<sup>48</sup>

Sharia however cannot be precisely considered as ‘Law’ or code of conduct *per se*, as it encompasses all human activities on which “human happiness, prosperity and progress depend.”<sup>49</sup> Muslims believe that Islam establishes public good, public interest, justice, mercy and wisdom and to them, these are the key to success in this World and the Hereafter. Hence, Sharia imposed dual obligations towards the believers, on the one hand, in relation to God and on the other, in relation to society.<sup>50</sup>

In the Islamic finance industry, sharia-compliance refers to acts based on Islamic principles. This includes the prohibition of (i) charging interest (Riba) – Riba literally means “an excess” and is interpreted as “any unjustifiable increase of capital whether in loans or sales”.<sup>51</sup> This is based on the arguments that the prohibition of Riba or interest is against social justice, equality and property rights.<sup>52</sup> Notably, the Sharia allows the earning of profits (as the religion encourages successful entrepreneurship) by justifying the extra profits determined *ex ante* (prior to the conclusion of the agreement), and not *ex post* (after the agreement is concluded); (ii) the prohibition of non-ethical investment activities (such as alcohol, prostitution or gambling); and (iii)

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<sup>47</sup> Ibid.

<sup>48</sup> Ibid.

<sup>49</sup> Syed Abul Hassan Najmee, *Islamic Legal Theory and the Orientalists*, (1989), p.19

<sup>50</sup> Ibid.

<sup>51</sup> Hossein Askari, Zamir Iqbal, Noureddine Krichene and Abbas Mirakhor, *The Stability of Islamic Finance: Creating a Resilient Financial Environment for a Secure Future*, (2010), p.4-5

<sup>52</sup> Ibid.

the prohibitions of speculative behavior (Islamic finance prohibits transactions involving uncertainties including gambling, and any transactions involving high levels of risk).<sup>53</sup> Theoretically, the reference to Sharia-compliance indicates that transactions are considered lawful under Sharia principles and non-Sharia compliance refers to unlawful transactions as prescribed by Sharia. In practice, Sharia-compliance is a transaction that is considered lawful (only) according to the legal opinion (fatwa) of a particular scholar or group of scholars. Therefore, a transaction can be considered as lawful (Sharia-compliant) by one scholar or group of scholars in a board of the same sitting while other scholars may consider it unlawful.

### ***Islamic Banks, Islamic financial sector, the inherent nature of Islamic banks***

The usage of the term 'Islamic banks' in this research refers to Islamic banks' retail banking business in accordance with Sharia. The terms 'Islamic banking and financial services institutions' is used to indicate all types of Islamic banks, that is, both retail and wholesale Islamic banks. 'Islamic financial sector' includes the Islamic banking and financial services sector as a whole.

Islamic banks typically offer savings and current account deposits, financing products such as home finance and personal finance, internet banking, cheque books, and debit cards.<sup>54</sup> Some Islamic banks (such as Bank Islamic Malaysia Berhad and HSBC Amanah) also offer credit cards.<sup>55</sup>

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<sup>53</sup> Ibid.

<sup>54</sup> Rodney Wilson, *Legal, Regulatory and Governance Issues in Islamic Finance*, (2012), p.41

<sup>55</sup> See the products via <<http://www.bankislam.com.my/>> and <<https://www.hsbcamanah.com.my/>> accessed: 10 July 2015



The reference to the inherent nature of Islamic banks is based on Sharia-compliance requirements as well as the nature of Islamic banks, which considers the bank-customer relationship in terms of profit-loss sharing. In principle, under profit-loss sharing transactions the status of the creditor is as an investor and the debtor as a manager (or sometimes referred to as the entrepreneur). This is distinct from conventional finance principles where the status of the bank is as creditor (lender) and the customer as the debtor (borrower). Thus, in Islamic finance, the investor and the manager share the profit and losses as agreed upon the conclusion of the agreement. Another nature of Islamic finance is that money is considered as actual capital when it is joined with other resources in undertaking a productive activity.<sup>56</sup> Islam recognises the time value for money only when it acts as actual capital and not 'potential' capital (where there is no productive activity). Finally, the Islamic finance nature represents the discouragement of any transaction, which is against social justice such as exploitation of the contractual parties and any act which leads to informational asymmetry in general.<sup>57</sup>

### ***Level-playing field regulations***

The reference to the term level-playing field regulations indicates two contexts. First, the criteria of what constitute as level-playing field regulations as described in Section 1.6. Second, level-playing field regulations represents the view or idea of the UK and/or Malaysian regulators in respect of providing regulatory accommodation for Islamic banks.

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<sup>56</sup> Supra, Note. 32,p.4-5

<sup>57</sup> Ibid.

## **1.5 GENERAL METHODOLOGY**

The research methodology for this thesis is qualitative and primarily literature-based. As such, primary and secondary sources of information are referred to in carrying out the investigation and analysis. A small amount of primary data is used merely to support the arguments presented in this research. The investigation is made by gathering the data from interviews held with market players, mainly Islamic bankers. In particular, a set of research questions (pilot questions) were prepared for the market players pertaining to the performance of Islamic banks, the regulatory accommodation for Islamic banks in relation to the concept of level-playing field regulation (including the challenges and benefits for Islamic banks) and how Islamic banks were treated by the regulators. However, their views are rather personal, and do not necessarily represent the Islamic financial sector as a whole. The primary data gathering is then analysed and extracted to suit the discussion pertaining to the level-playing field regulations. For instance, the market players' views on the level-playing field regulations on authorisation process are discussed accordingly within the section on authorisation of the UK and Malaysian chapter. In sum, the usage of the primary data is carefully selected to suit the discussion in the relevant chapter.

Secondary data comprises of the most significant source of information in this legal research. These include law cases, general statements of the law, journal articles, official publications, statutory instruments and trusted online resources. The usage of secondary data is in fact, the primary source of this thesis. The research method-data analysis such as law cases were used to analysed the extent of judicial treatment towards Islamic banks. In particular, the law cases were used to identify whether Islamic banks were given any special treatment by the judicial courts.

In both chapters (the UK and Malaysia), the law cases that were chosen as an authority are those that represent significant law judgment on Islamic banking issues, and analysis were made in relation to the question of level-playing field based on the court's judgment. General statements of the law from regulatory authorities were also used in order to determine and interpret a particular legal treatment over issues discussed in this research. Journal articles were carefully selected from the internationally recognised publications to develop and support the research discussion as well as a supporting reference for this research. Official publications from the banking and financial regulators in the UK and Malaysia, were used to analyse the regulatory accommodation for Islamic banks in the UK and Malaysia. In particular, the extent of the regulators' treatment on Islamic banks and to what extent their treatment represents the concept of level-playing field. Additionally, official publications were also gathered from the international regulatory authorities for the banking and financial institutions worldwide.

In examining the regulation for Islamic banks, statutory instruments in the UK and Malaysia were used. Statutory instruments governing the Islamic banks such as the Financial Services and Markets Act 2000 (UK), Financial Services Act 2012 (UK), Islamic Financial Services Act 2013 and Financial Services Act 2013 (Malaysia) have helped this research to identify the particularities of the regulatory accommodation for Islamic banks. For example, the regulation pertaining to authorisation process of Islamic banks and taxation helped this research to analyse whether the existing regulatory accommodation reflects the concept of level-playing field for Islamic banks.

In some aspect of this research, other secondary data such as online resources were used. The usage of the online resources as a reference in this research was used to further support the discussion of this research. For instance, the discussion on taxation in this research depends somewhat heavily on online resources for the fact that there is limited information on other secondary data. Moreover, the general news on Islamic banks was gathered from trusted online websites. In sum, the usage of the secondary data is considered as significant source of data which helps this research to reach its findings based on the primary and subsidiary research questions. Therefore, given that the nature of the research, and its primary function, the use of secondary data is considered the most appropriate and authoritative.

With regards to the research design of this thesis, the usage of all the materials from the primary and secondary data was used as the tool to construct the whole structure of this thesis. While there is an absence of detailed research on the level-playing field regulations for Islamic banks and its criterion, the discussion on the topic of level-playing field in other fields provides inspiration for the author to construct this research in a detailed manner. The references to primary and secondary data have inspired the author to extract the potential factors to determine what constitute as level-playing field regulations (its criterion) for Islamic banks in an orderly manner. The criterion is then used to identify the extent of the level-playing field regulations. Subsequently, the chosen examples of the regulatory accommodation for Islamic banks (for example, authorisation process, liquidity regulation, taxation, judicial cases, etc) were incorporated with the discussion on the possible criterion of level-playing field regulation (for example, the question of whether the authorisation of Islamic banks

represents formal equality or substantive equality and whether such regulations represents a level-playing field regulations).

With regards to the chapters' allocation in this thesis, the discussion on level-playing field regulations and the rationale for banking regulations were allocated as the beginning chapter of this thesis. This is to provide the readers on the foundational issues for banking regulation and the idea of level-playing field regulations. The examination of the level-playing field regulations for the UK and Malaysia is allocated in separate chapters for systematic arguments and presentation. The arguments and analysis developed from chapter two to four is further analysed in chapter five. Finally, the conclusion chapter concludes the findings as founded from the analysis of all the earlier chapters.

Additionally, since the research involves a comparative legal study on the regulation governing Islamic banks in the UK and Malaysia, a comparative law methodology is employed. Therefore, the next section provides the definition, scope, strengths and weaknesses of comparative law.

### **1.5.1 COMPARATIVE LAW**

The history of the comparative law study begins as early as the Greek period where Plato compared the legal structures of the Greek city-states and Aristotle made a comparative enquiry on 153-city state constitutions.<sup>58</sup> Comparative law study has been established since then, from the Roman Empire, until today. The area of comparative law study has now expanded from purely legal studies to economic, social, cultural

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<sup>58</sup> Stanley N. Katz (ed), *The Oxford International Encyclopedia of Legal History*, (2009), (vol.2), p.97

and religious studies across borders.<sup>59</sup> Comparative law has been defined by various scholars in different ways, albeit the substance remains similar. There is no exhaustive and binding definition for the term 'Comparative law'. The most celebrated definition is by Zweigert and Kötz, where comparative law is described as an "intellectual activity with law as its object and comparison as its process".<sup>60</sup> Others define comparative law as "the study of the relationship of one legal system and its rules with another"<sup>61</sup>; "simultaneously studied side by side."<sup>62</sup>

Comparative law pertains to hermeneutic (the understanding of the institutional setting out of which the law arises and is used), explanatory (explaining the law, explaining the differences and similarities), empirical (determining the best legal means), logical (coherence, structuring concepts, rules and principles), instrumental (concept-building) and critical evaluation.<sup>63</sup>

The significance of comparative law comprises the juxtaposition and harmonisation of the rules of the legal systems of the world and it involves the extra element of internationalism.<sup>64</sup> Its purpose is not only law reform, or to offer itself as a research tool, or to promote international understanding, but to fulfill its essential task of furthering the universal knowledge and understanding of the phenomenon of law.<sup>65</sup>

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<sup>59</sup> Ibid., p.100

<sup>60</sup> Konrad Zweigert and Hein Kötz, *An Introduction to Comparative Law*, (1998), p.2

<sup>61</sup> Alan Watson, *Legal Transplants: An Approach to Comparative Law*, (1993), p.6

<sup>62</sup> Jaako Husa, "Comparative Law, Legal Linguistics and Methodology of Legal Doctrine" in Van Hoecke, *Methodologies of Legal Research*, (2011), p. 210

<sup>63</sup> Van Hoecke, *Methodologies of Legal Research*, (2011), Preface.

<sup>64</sup> Supra, Note 61, p.4

<sup>65</sup> Ibid.

Thus, “comparative law affords us a glimpse into the form and formation of legal institutions which develop in parallel, possibly in accordance with laws yet to be determined, and permits us to catch sight, through the differences in detail, of the grand similarities and so to deepen our belief in the existence of a unitary sense of justice.”<sup>66</sup> It is used to provide ideas for the necessary changes to the legal systems or institutions to be harmonised, to smooth the process or suggest the creation of a model law or a unified law.<sup>67</sup> With regards to this research, the usage of comparative law methodology helps the analysis on the similarities and differences of regulatory accommodation from the context of level-playing field regulations for Islamic banks in both countries - the UK and Malaysia. The comparative law methodology also enables this research to highlight the international understanding on the level-playing field regulations for Islamic banks in a different regulatory architecture of these two common law systems and to analyse the effectiveness of the level-playing field regulations in both legal systems.

Comparative legal research enables the international harmonisation of law to be developed to achieve international legal standards through the concept of legal transplants. Legal transplants denote “the moving of a rule or a system of law from one country to another, or from one people to another.”<sup>68</sup> From this concept, this research considers the possibility of adopting a legal transplant by borrowing a positive aspect of a particular legal framework from a foreign legal system (e.g., Malaysia) into the domestic legal system (UK).

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<sup>66</sup> Ibid.

<sup>67</sup> Esin Özü, “Developing Comparative Law” in *Comparative Law Handbook*, (2007), Esin Özü and David Nelken (eds), p. 56

<sup>68</sup> Alan Watson, *Legal Transplants: An Approach to Comparative Law*, (1993), p. 23

In comparative law, there are two units of comparison that can be useful for research analyses.<sup>69</sup> One unit involves the comparison of spirit and style of different legal systems; concentrating on the methods of thought and procedures they use. This is referred to as 'macro comparison'. Thus, instead of concentrating on individual concrete problems and their solutions, the principle for macro comparison denotes "the research method of handling legal materials, procedures for resolving and deciding disputes or the roles of those engaged in law."<sup>70</sup> Macro comparison is also extended to the comparative analysis between legal systems with other existing systems: the societal, cultural, political and economic.<sup>71</sup>

'Micro comparison' deals with specific legal institutions or problems, that is, the rules used to solve actual problems or particular conflict of interests.<sup>72</sup> It can be suggested that the two units cannot stand on their own. Both of the units are interrelated in carrying out the comparing process. As Örücü states,

"...macro comparison and micro comparison should merge, since the micro comparative topic must be placed within the entire legal system. Hence, macro comparative unit, that is, the totality of the legal system in context, is the frame within which all is contained and evaluated."<sup>73</sup>

Zweigert and Kötz state,

"The dividing line between macro comparison and micro comparison is admittedly flexible. Indeed, one must often do both at the same time, for often one has to study

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<sup>69</sup> Supra, Note. 58, p. 4

<sup>70</sup> Supra, Note. 68, p. 56-58

<sup>71</sup> Ibid.

<sup>72</sup> Supra, Note. 61, p. 5

<sup>73</sup> Supra, Note. 67, p. 57



the procedures by which the rules are in fact applied in order to understand why a foreign system solves a particular problem in the way it does.”<sup>74</sup>

In light of the above, the method of this research calls for the usage of both categories. The usage of macro-comparison helps this research to compare how the UK and Malaysia are treating Islamic banks within their regulatory framework. Macro comparison also helps this research to compare the legal procedures adopted by both countries and identify the regulators’ approach in resolving the issues of Islamic banking. Additionally, adopting macro-comparison method enables this research to describe the regulator’s motivation of regulating Islamic banks and ultimately helps this research to reach its findings. Whereas the usage of micro-comparison enables this research to examine the specific regulatory area affecting Islamic banks and helps the discussion of a particular regulatory area from the context of level-playing field regulations. In light of this, micro-comparison method facilitates this research in reaching its conclusion on the effectiveness of the level-playing field regulations in both states as well as the usefulness of the idea of the level-playing field regulations in general.

In sum, the usage of comparative law methodology will help this research to contextualise the legal framework as a whole and to critically evaluate what has been discovered from the comparative analysis. Additionally, the method of contextualising helps this research to examine the conceptual structure within which legal problems emerge and the extent to which the rules are operated.<sup>75</sup>

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<sup>74</sup> Supra, Note. 60, p. 5

<sup>75</sup> Ibid.

It has been suggested that in order to fulfill the requirements of scholarly comparative legal research, “it is not only to consider the similarities and differences, but also to observe what is actually there.”<sup>76</sup> Therefore, based on what is provided in the regulatory framework, this research takes a step further by identifying the *lacunae* in the law and elicit potential risks behind the existing regulation.

Comparative law study as a methodology for legal research has its advantage and disadvantages which will invariably affect this research project. To start with, I shall discuss some of the disadvantages before moving on to the advantages.

Comparative law has no power to lay down rules to assist the comparatist in decision making<sup>77</sup> as any study of comparative law will be subjective, and no objective test will demonstrate that the aspects considered were the most appropriate.<sup>78</sup> Thus, comparative law research is often regarded as superficial,<sup>79</sup> “unsystematic, incomplete, a thing of shreds and patches.”<sup>80</sup> With respect to this research, the comparative analysis of chapter three and four differs in certain aspect pertaining to the type of regulation for Islamic banks. This is for the fact that a particular type of regulation does not exist in either one of the two countries. For instance, chapter three (the UK chapter) discussed the regulation on Home Purchase Plan whereas there is no discussion as such in chapter four (the Malaysian chapter). (This is due to the fact that there is no such regulation as such in Malaysia). In certain aspect, there is no

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<sup>76</sup> Supra, Note 58, p. 50

<sup>77</sup> Bernhard Grossfeld, *The Strength and Weakness of Comparative Law*, (1990), p.7

<sup>78</sup> Alan Watson, *Legal Transplants: An Approach to Comparative Law*, (1993), p.11

<sup>79</sup> Ibid.

<sup>80</sup> Supra, Note. 58, p.39

discussion on a particular type of regulation although such regulation does exist. For instance, the regulatory decision making process as examined in the chapter three is not examined in chapter four because there is no pertinent issue with regards to the level-playing field regulation to be discussed (although there is decision-making process do exist in the Malaysian regulatory framework).

The legal system of the world varies from one country to another, from one institution to another, and none of them are the same. In the field of comparative law studies, finding the exact counterparts in different systems is hardly possible. Grossfeld asserts that the difficulty in comparative legal studies relates to the suitability of comparisons. In particular, how one chooses which legal institution to be compared with, and in which legal system. He sees that this problem is something which is not too acute with Western European cultures, but difficulties arise when one is making comparison with Africa and Asia. Thus, he argues that to decide whether an institution is transferable, or what adaptation is possible, is an issue in comparative law study.<sup>81</sup>

Additionally, as mentioned earlier, there is no standard methodology for a comparative lawyer to adopt,<sup>82</sup> therefore the task to determine a meaningful comparison is harder – as Zweigert and Kötz assert, “incomparables cannot usefully be compared, and in law the only things which are comparable are those which fulfill the same function.”<sup>83</sup> With regards to this research, the ‘comparable thing’ refers to the regulatory

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<sup>81</sup> Ibid., p. 38

<sup>82</sup> Supra, Note. 60, p. 50

<sup>83</sup> Ibid, p. 34

institutions for the banking institutions in the UK and Malaysia. The regulatory institutions are deemed to have the same function.

The variations mentioned above are the factors that contribute to the difference in legal culture. Even if one finds that the countries in comparison are from the same legal family,<sup>84</sup> (for example, the UK and Malaysia as common law family), what makes the law regulated in such a manner depends on the regulatory culture of each country and the intention of the regulator. Therefore, the regulatory framework for Malaysia may not be appropriate for the UK and vice versa. In short, clear cut answers from comparative legal research can rarely be provided.<sup>85</sup> In particular, this research is unable to suggest which regulatory framework is more suitable to be adopted for the regulations of Islamic banks, but in some aspect of the regulatory accommodation, it does suggest how well the regulations accommodate Islamic banks within the context of level-playing field. This research supports the sayings that comparative law study is nothing more sophisticated than empirical observation<sup>86</sup> and “comparative law cannot be evaluative because it ‘gives no guidelines’ as to which legal solution might be the better one”.<sup>87</sup>

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<sup>84</sup> Legal families have been introduced by scholars to arrange the mass legal systems of the world.

<sup>85</sup> Nicholas Foster, “Comparative Commercial Law” in Esin Örüçü and David Nelken (eds), *Comparative Law Handbook* (2007), p. 280

<sup>86</sup> Mitchel De S.-O.L’ E. Lasser, *The Question of Understanding*, (2003), p.199. Pierre Legrand argues that “even the most sophisticated comparative analysis originating from one tradition will, ultimately fail to cross epistemological boundaries.” Pierre Legrand, “Alterity: About Rules for Example” in Peter Birks and Arianna Pretto (eds), *Themes of Comparative Law*, (2004), p.22

<sup>87</sup> Ralf Michaels quoted in James Gordley, ‘ The Functional Method’ in Giuseppe Monateri (ed), *Methods of Comparative Law*, p.109

In spite of all this, comparative law research provides certain advantages. Comparative law analysis may improve the legal development of a particular country. It may expose foreign views on the domestic law and help the domestic legal system to learn from other foreign legal systems, although not necessarily to absorb or implement foreign law.<sup>88</sup> Comparative law analysis will enable domestic legal institutions to elicit the essentials of the domestic law. Grossfeld opines that comparative law “relieves us the aridity of national self-contemplation, shows us how it may be misunderstood abroad, and helps us to reach the foreign ear.”<sup>89</sup>

Additionally, the comparative law analysis will facilitate the domestic legal system to consider “whether it is possible to accept foreign solutions with modifications or without modifications”.<sup>90</sup> In other words, the facilitation of comparative law analysis will help this research to identify the positive approach of one legal system to another.

Another comparative aspect of this research involves the institutional and public policy comparisons with regards to the level-playing field regulations and its effectiveness for the Islamic banking sector between the UK and Malaysia. In particular, this research is comparing the institutional and public policy aspect as part of the analysis. As the conclusion chapter shows, more success in the level-playing field regulation for Islamic banks can be inferred from the Malaysian model due to its dual regulatory framework which derived from the government’s institutional and public policy. Whereas the UK model which treats Islamic banks within a single regulatory framework (as part of the

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<sup>88</sup> Supra, Note. 58, p.113

<sup>89</sup> Ibid.

<sup>90</sup> Supra, Note. 60, p. 16

government's institutional and public policy) shows that there are more substantive issues that give rise to some challenges for Islamic banks.

### **1.5.2 LEVEL-PLAYING FIELD REGULATIONS TEST**

In examining whether the level-playing field regulations for Islamic banks has been enabled by the regulators in the UK and Malaysia, two test questions are referred to:

- (i) Whether Islamic banks are treated equally before the law; and
- (ii) Whether Islamic banks are given a fair opportunity to compete alongside the conventional banks.

As the following chapter argues, the two questions above reflect the elements that should exist concurrently in the level-playing field regulations for Islamic banks. The detailed prescription of this test is discussed in the next chapter under Section 2.3. It has also been stated in the next chapter that another approach to determine whether the playing field is level, is by asking when the level-playing field can be regarded as distorted. In other words, the answers to the above questions reflect an obvious, not a mere, negative outcome. This approach is also mentioned further in the next chapter under Section 2.3.

## **1.6 SCHOLARLY CONTEXT**

Earlier research has influenced the direction and focus of this study. Earlier literature inspired the existing research on Islamic banks with respect to the regulatory accommodation and the inherent nature of Islamic banks. The previous studies have

shown that the theoretical nature of Islamic banks and its practices have exposed Islamic banks to certain types of risk. It has been commonly argued that the stability of Islamic banks can be adversely affected with the existence of the risks identified.

To my knowledge, thus far there is no research which has dealt with the concept of level-playing field regulations in a detailed manner and whether banking regulators have enabled the level-playing field regulations for Islamic banks. This research, therefore, combines the discussion in the existing literatures and focuses on investigating the areas which have not been explored by authors in their published works.

Aldohni<sup>91</sup> provides an insight into the legal aspects of the Islamic financial sector in the UK and Malaysia. He described the legal accommodation for Islamic banks in these two countries as well as analysing the legal impediments arising from such legal accommodation. He proposed that more regulation should be given to Islamic banks to enable the sector to develop. His comparative research can be said to be similar to this research (in particular, the subject of Islamic banking and the countries in focus are the same); nevertheless, his research does not focus on the context of level-playing field regulations. Rather, his work aims to provide a general overview of the practices between the two countries without aiming to examine a specific theme within the comparative study.

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<sup>91</sup>Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking*, (2010)

Housby<sup>92</sup> provides a general overview of the products and services provided by Islamic financial institution in the UK. Based on her overview of the products and services, she describes the strengths and weaknesses of the current products and services available in the market without venturing into further theoretical details. Her work also highlights several issues which concerns the British Muslims who are the main consumer of Islamic financial services in the UK. Due to the scope that she focuses on, however, the regulatory framework governing Islamic banks in the UK was disregarded.

In recent years, there has been a considerable amount of literature published<sup>93</sup> on the general overview of the history, theories, principles and practice of Islamic banking. These literatures focus on providing a theoretical understanding on the nature of Islamic finance and its operations without further discussion on issues related to Islamic banks.

Growing volumes of literature<sup>94</sup> have provided in-depth analysis on the type of risks attached to Islamic banks. Comparative analyses have been made between the

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<sup>92</sup> Elaine Housby, *Islamic Financial Services in the United Kingdom*, (2011)

<sup>93</sup> Fuad Al-Omar and Mohammed Abdel- Haq, *Islamic Banking: Theory, Practice and Challenges* (1996) OUP: Karachi; Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, (2012), Muhammad Ayub, *Understanding Islamic Finance*, (2007), Brian Kettell, *An Introduction to Islamic Finance*, (2008), Hans Visser, *Islamic Finance: Principles and Practice*, (2009), Sami Hassan Homoud, *Islamic Banking*, (1985)

<sup>94</sup> Dahlia El-Hawary, Wafik Grais and Zamir Iqbal, 'Diversity in the Regulation of Islamic Financial Institutions', (2007), Alejandro López Mejia, Suliman Aljabrin, Rachid Awad, Mohamed Norat and Inwon Song, 'Regulation and Supervision of Islamic Banks', (2014), Nafis Alam, 'Impact of Banking Regulation on Risk and Efficiency in Islamic Banking', (2013), Pejman Abidefar, Philip Molyneux, Amine Tarazi, 'Risk in Islamic Banking', (2012), Martin Čihák and Heiko Hesse, 'Islamic Banks and Financial Stability: An Empirical Analysis', (2008), Sundarajan and Luca Errico, 'Islamic Financial Institutions and Products



operational aspects of Islamic financial intermediation in practice with its conceptual foundations. Moreover, comparative analyses have been conducted between Islamic and conventional banks. These literatures highlight the risks and challenges which Islamic banks are exposed to through the legal framework, corporate governance and supervision. Risks, which Islamic banks are exposed to, were identified as impacting upon Islamic banks differently as compared to conventional banks. It was also found that in certain types of risk, Islamic banks can be more heavily affected than the conventional banks while in some other instances, the conventional banks suffer more risk than Islamic banks. In their research on the risks and challenges facing Islamic banks, authors have suggested that an appropriate regulatory framework is essential for the stability of Islamic banks.

Blair et al.<sup>95</sup> and Henderson<sup>96</sup> provide an in-depth description on the regulatory governance for the Islamic financial sector in the UK. In particular, the authors highlighted the aspect of authorisation and categorisation of Islamic financial products within the UK's conventional regulatory framework. Several regulatory issues were raised with respect to the conventional regulatory framework governing Islamic banks in the UK. The authors found that the conventional regulatory framework does not fully compliment the operational aspect of Islamic banks.

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in the Global Financial System: Key Issues in Risk Management and Challenges Ahead', (2002), Khadidja Khaldi and Amina Hamdouni, 'Islamic Financial Intermediation', (2011), Simon Archer and Rifaat Abdel Karim, 'Corporate Governance, Market Discipline and Regulation of Islamic Banks', (2006)

<sup>95</sup> Michael Blair, George Walker, Robert Purves, *Financial Services Law*, (2009)

<sup>96</sup> Andrew Henderson, 'Islamic Financial Institutions' in Craig R. Nethercott and David M. Eisenberg (eds), *Islamic Finance: Law and Practice*, (2012)

Greuning and Iqbal<sup>97</sup> provide a detailed analysis on the risks which Islamic banks are exposed to. They identify that the nature of Islamic financial intermediation, which deviates from its theoretical aspects, threatens the stability of Islamic banks. Comparative analyses were made between the operations of Islamic banks and the conventional banks. Their analyses have shown that various types of risks could potentially affect the operations and stability of Islamic banks if they are not fully addressed.

Several studies<sup>98</sup> have discussed the concept of level-playing field in separate fields such as international financial regulation, economic justice, international law, and US financial regulation. In each study, authors have discussed the concept of level-playing field and made an attempt to interpret the concept of level-playing field with regards to their research subject. In sum, it can be inferred that the concept of level-playing field represents fair treatment.

## **1.7 RESEARCH STRUCTURE**

### **Part 1: Level-playing field regulations**

This thesis consists of six chapters. Part one comprises of chapter two which prepares a foundation for the discussion of whether there is a need to regulate Islamic banks

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<sup>97</sup> Hennie Van Greuning and Zamir Iqbal 'Banking and the Risk Environment' in Simon Archer and Rifaat Abdul Karim (eds), *Islamic Finance: The Regulatory Challenge* (2007)

<sup>98</sup> Alan Morrison and Lucy White, 'Level-Playing Fields in International Financial Regulation', (2009), Surya P. Subedi, 'The Notion of Free Trade and the First Ten Years of the World Trade Organization: How Level is the "Level-Playing Field?"', (2006), Ethan B. Kapstein, 'Economic Justice in an Unfair World: Towards a Level-Playing Field', (2007), Helen A. Garten, *U.S Financial Regulation and Its Implications for the Global Marketplace*, (2001)

more than what the existing regulations have provided for. This chapter provides the examination and analysis on the rationale for banking regulations, and whether there should be more regulation for Islamic banks. It was found that level-playing field regulations is not a useful concept, not only because the regulators have failed to enable the level-playing field regulations but also because the rationales underlying banking regulations have made the concept of level-playing field regulations for Islamic banks unworkable. Additionally, this chapter discuss the various interpretations of the notion level-playing field. This chapter interprets the notion level-playing field regulations for Islamic banks and establishes several factors which are seen to be a challenge for the level-playing field regulations.

## **Part 2: Level-playing field regulations for Islamic banks**

Part two of this thesis consists of chapters three and four. Chapter three analyses the regulatory accommodation governing Islamic banks in the UK. Examples of regulatory accommodation are examined within the context of level-playing field regulations. This chapter highlights the regulatory governance for Islamic banks within the conventional regulatory framework and concludes that the UK's regulators have not fully enabled the level-playing field regulations for Islamic banks.

Chapter four analyses the regulatory accommodation for Islamic banks in Malaysia under its dual regulatory framework. Similar to the approach used in the previous chapter, this chapter examines the regulatory accommodation for Islamic banks within the context of level-playing field regulations. It is found that while the Malaysian regulatory framework appears to create level-playing field regulations for Islamic

banks, there remain certain aspects of the regulatory accommodation in which the level-playing field regulation is not fully enabled.

### **Part 3: Level-playing field and the impacts of the regulation on Islamic banks**

Following from the examination and analyses on the level-playing field regulations governing Islamic banks in the UK and Malaysia, chapter five of this thesis discussed the impacts of the level-playing field regulations on Islamic banks. From the lists of impacts of the existing regulatory accommodation, it is found that the UK and Malaysian regulators have not enabled the level-playing field regulations in totality within the conventional regulatory framework (UK) and the dual regulatory framework (Malaysia).

### **Part 4: Conclusion**

The final part of this thesis is contained in chapter six where a conclusion is drawn out based on the examination and analyses of the earlier chapters. The conclusion chapter highlights the issues addressed in the preceding chapters regarding the level-playing field regulations for Islamic banks. The research concludes that several factors are responsible for preventing the level-playing field regulations from being a useful concept. These factors include the challenges and realities of the financial system, the concept of level-playing field regulations which poses challenges and risks towards Islamic banks, the failure of regulators to enable the level-playing field regulations, and the rationales of banking regulations which effectively make level-playing field regulations unworkable. The findings of this research build some direction for future research.

## **CHAPTER TWO: IN SEARCH OF ‘LEVEL-PLAYING FIELD’: CHALLENGES AND REALITIES**

### **2.1 INTRODUCTION**

### **2.2 THE RATIONALES FOR BANKING REGULATION**

- (i) Anti-competitive behaviour**
- (ii) Market misconduct**
- (iii) Information asymmetries**
- (iv) Systemic stability**

### **2.3 ARGUMENTS ON BANKING REGULATIONS**

#### **2.3.1 ‘More regulation’ argument**

- (i) Bank’s prudential as justification for more regulation**
- (ii) Sector’s development as justification for more regulation**
- (iii) Transparency as justification for more regulation**

#### **2.3.2 ‘Less is more’ argument (Simple regulation)**

- (i) Cost-benefit analysis of regulation as justification for simple regulation**
- (ii) Ex ante and ex post as justification for simple regulation**
- (iii) Buy what you understand as justification for simple regulation**
- (iv) Platforms for dispute resolution as justification for simple regulation**
  - (a) Sharia Supervisory Board (SSB)**
  - (b) Arbitration and mediation**
  - (c) Ombudsman and Courts of Law**
- (v) Societal background as justification for simple regulation**
  - (a) The United Kingdom**

**(b) Malaysia**

**(vi) Other international regulatory standards as justification for simple regulation**

**2.4 IN SEARCH OF LEVEL-PLAYING FIELD**

**2.5 INTERPRETING LEVEL-PLAYING FIELD**

**(i) Whether Islamic banks are treated equally before the law**

**(ii) Whether Islamic banks are given a fair opportunity to compete alongside the conventional banks**

**2.6 LEVEL-PLAYING FIELD: CHALLENGES AND REALITIES**

**(i) Legal pluralism**

**(ii) Legal change**

**(iii) Level-playing field and the risks to Islamic banks**

**(iv) Level-playing field and Islamic banks' stability**

**2.7 CONCLUSION**

## 2.1 INTRODUCTION

In the first chapter, it was highlighted that the notion of 'level-playing field' has been the concept used by the UK and Malaysian regulators in indicating their regulatory treatment towards all the banking and financial services institutions.<sup>99</sup> Despite this, it is also important to question the rationale of banking regulations and whether the idea of level-playing field regulations is necessary for Islamic banks to be subjected to more regulations. Therefore, the subsequent section analyses the rationale for banking regulations and considers whether Islamic banks should be subject to more regulations. Based on the rationale for banking regulations and the justifications for more/simpler regulations for Islamic bank, this chapter argues that: (i) simple regulations for Islamic banks are more desirable (especially in the UK context) (ii) level-playing field regulations could not be enabled based on the rationales and justifications for more/simple regulations.

This chapter also concludes that while it is important to address the risks exposed to Islamic banks, it is not necessary to have a separate regulatory framework to create a level-playing field. What is needed is an appropriate regulation for Islamic banks which could help the sector to develop. As such, this chapter suggests that a simple regulatory framework for Islamic banks is more desirable.

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<sup>99</sup> Michael Ainley, Ali Mashayeki, Robert Hicks, Arshadur Rahman and Ali Ravalia, 'Islamic Finance in the UK: Regulation and Challenges', (2007), p.17, HM Treasury, 'The Development of Islamic Finance in the UK: The Government's Perspective', (2008), p.3, BNM, 'New Opportunities, New Market and New Frontier in Islamic Banking & Finance', (Governor's speech), (August 2004) via <<http://www.bnm.gov.my/>> accessed: 5 July 2015

Additionally, this research also argues that in reality, there is complexity and diversity in the financial system through the financial innovation and competition that the banking regulators have always encouraged. The notion of level-playing field is seen to be the benchmark for regulating the banking and financial institutions in order to neutralise or balance the complexity and diversity in the financial system by regulators globally and domestically. In the UK, the principle of “the avoidance of giving any special favours to one group of financial services over the other”<sup>100</sup> reflects the concept of level-playing field used by the financial regulators in the banking and financial regulatory framework. For the Malaysian banking and financial regulatory framework, the treatment of level-playing field can be inferred from the dual regulatory framework through which the conventional and Islamic banks operate.

However, as mentioned in the preceding chapter, such a form of expression is unclear. Level-playing field is an open-ended concept. There is no clear-cut understanding of what is a level-playing field, or the level-playing field of what, for there is an absence of a standard definition on what constitutes as a level-playing field. And determining what level-playing field could mean is important for the fact that such an expression is repeatedly used by financial regulators in indicating their approach towards the treatment for banking and financial services institutions that they govern (some of the examples on the level-playing field treatment are provided in the later part of this chapter). As such, the expression can be said to have its significance with regards to the regulators’ approach towards regulating banking and financial services. Interpreting what level-playing field could mean and the understanding of the basic

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<sup>100</sup> HM Treasury, ‘The Development of Islamic Finance in the UK: The Government’s Perspective’, (2008), p.17



functions of law is essential – so that certain basic criteria can be established. What can be inferred later in the chapter is that the concept of level-playing field is seen to collide with the uncertainties in the system that we live in. The concept of a level-playing field regulation for Islamic banks is argued to be a useless concept. This is due to the challenges and realities that are discussed in this chapter.

Apart from the reality of the complexity and diversity in the financial system mentioned in the preceding chapter, this chapter further argues that the challenges arises from the vagueness in interpretation of the notion of a level-playing field itself. Secondly, the nature of the law (which also includes legal pluralism and legal change) and the objectives of banking regulation do not coincide with the concept of level-playing field. Thirdly, the concept of a level-playing field regulation is unable to address the risks Islamic banks are exposed to. Fourthly, the concept of level-playing field regulation is challenged when it could not be associated with the stability of Islamic banks. Hence, while the notion of level-playing field (which is regarded as the metaphor of fairness) is considered to be a valid expression, its value is questionable.

This chapter consists of six main sections. It begins with highlighting the rationales of banking regulations and followed by the arguments on banking regulations. The third section shows the variations of interpretations on level-playing field. Following the discussion, analysis and conceptualisation of the notion of a level-playing field within the context of Islamic banks are presented. These are contained in the fourth section. Additionally, this section provides a brief highlight on the general nature of law and the general criteria of equality and fairness. Note that the discussion on the nature of law, justice and fairness is merely to highlight its basic concept, thus it is beyond the

objective of this chapter to discuss in great-depth any philosophical or jurisprudential sense of law and fairness. Similarly, note that a philosophical discussion is not intended in interpreting the level-playing field but rather how it affects the practical aspect of applying the regulations. The fifth section discusses the challenges and realities that seem to collide with the level-playing field regulations for Islamic banks. The final section concludes.

## **2.2 THE RATIONALES FOR BANKING REGULATION**

A large body of literature has argued that banking regulations help to create financial stability, development and growth.<sup>101</sup> Regulation, in a broader context, refers to:

“Legal rules which seek to steer the behaviour of mainly private citizens and companies but also of central and local government as well as public agencies.”<sup>102</sup>

The rationales for banking regulation can be viewed from two perspectives - legal and economic. From the legal perspective, there are four main rationales for regulating banks: to avoid externalities which could result in anticompetitive behaviour; to avoid market misconduct; to minimise information asymmetries and to

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<sup>101</sup> Eva H. G. Hüpkens, 'Managing Financial Failure, Evolving Economic and Financial Environment' in Robert R. Bliss and George G. Kaufman (eds), *Financial Institutions and Markets: Current Issues in Financial Markets*, (2008), p.86, Gerard Caprio Jr and Patrick Honohan, 'Banking Crises' in Allen N. Berger, Philip Molyneux and John O.S. Wilson (eds), *The Oxford Handbook of Banking*, (2010), p.689, Frederic S. Mishkin and Stanley G. Eakins, *Financial Markets and Institutions*, (2006), p.534

<sup>102</sup> Cane Conaghan, *The New Oxford Companion to Law*, (2008), p.996

avoid systemic instability.<sup>103</sup> From an economic perspective, financial regulation (which includes banking institutions) 'seeks to address a variety of problems that occur when finance is left solely to market forces.'<sup>104</sup>

The next part discusses the four main rationales for banking regulations from the legal perspective.

### **(i) Anti-competitive behaviour**

It has been argued that regulation plays a role in monitoring anti-competitive behaviour among banking institutions. This regulatory objective aims to eliminate any existing monopoly in the financial sector. Without an appropriate regulatory framework, financial institutions may exert unfair and undue influence over information that they generate.<sup>105</sup> One of the roles of banking regulations, therefore, is to help Islamic banks and conventional banks to have fair access to information 'to promote a fair and open competition, and reasonable access to systems and information.'<sup>106</sup> In this regard, regulation can encourage banking and financial institutions to compete on a level-playing field.

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<sup>103</sup> Douglas W. Arner, *Financial Stability, Economic Growth and the Role of Law* (2007) (SOAS e-library)

<sup>104</sup> Ibid.

<sup>105</sup> Charles Goodhart, Liliana Rojas-Suárez, Steven Weisbrod, *Financial Regulation: Why, How and Where Now?*, (2001), p.4

<sup>106</sup> Ibid.

## **(ii) Market misconduct**

Banking regulation is essential to eradicate market misconduct by banking and financial institutions. This is due to the fact that customers' money is always at risk and fraud in the banking sector is common.<sup>107</sup>

In the UK, the Financial Conduct Authority through its conduct of business regulation requires all banking institution to deliver 'clear, fair and not misleading information to the customers'.<sup>108</sup> Conduct of business regulation focuses on 'how firms conduct their business with customers' and they are designed 'to establish rules and guidelines about appropriate behaviour and business practices in dealing with customers'.<sup>109</sup> It has been argued that the issues pertaining to customer protection within the financial sector are more crucial than in other professions.<sup>110</sup>

For Islamic banks, conduct of business regulations is important to build market confidence for this new financial sector. It is vital in order to monitor the behaviour of Islamic banks so that non-Sharia-compliant risk can be mitigated. The fact that the Islamic financial sector is relatively new in the financial market means an appropriate conduct of business regulation is essential for the development of Islamic banks. While the Islamic finance sector is relatively new, the sector has

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<sup>107</sup> David Llewelyn, Christopher J. Green, *Financial Markets and Institutions*, (1991), p.6. It is reported that every year, more than £300,000 are stolen from customers' bank accounts mainly from online and credit card transaction. See, BBC Watchdog, 'Bank Fraud: Easy to be a victim – hard to get your money back?' via <<http://www.bbc.co.uk/programmes/articles/>> accessed: 10 July 2015

<sup>108</sup> FCA, 'The Banking Conduct Regime', via <<http://www.fca.org.uk/firms/being-regulated/banking/Conduct-regime>> accessed: 15 July 2015

<sup>109</sup> Supra, Note. 107, p.6

<sup>110</sup> Ibid.

been hampered by allegations before the courts of law that their business transactions are non-Sharia compliant (Cases are mentioned in the previous chapters.) The existing evidence proves that such allegation imply that there is a lack of clear information delivered to customers when the issue of non-Sharia compliance was raised. As a result, the non-Sharia-compliant cases pose risks to the reputation of the Islamic financial sector and market confidence in Islamic banks.

While there is no specific research to examine the extent to which market confidence is affected due to the non-Sharia-compliance issues of Islamic banks, nonetheless, recent research has demonstrated that market confidence and customers' loyalty towards Islamic banks may vary over time.<sup>111</sup> One of the main reasons is the quality of conduct of business (service quality) of Islamic banks. Surveys have shown that there is always a tendency for customers to switch banks due to this factor apart from other factors such as the diversity of products offered and attractive profit returns.<sup>112</sup> Due to this, it has been argued that proving the Sharia-compliant aspect of Islamic banking products *per se* is not sufficient to sustain market confidence. Islamic banks are expected to convince customers that their conduct of business is based on different values from the conventional banks.<sup>113</sup> Banking regulation, therefore, plays an important role in promoting market confidence within the Islamic financial sector.

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<sup>111</sup> Mohammad Ziaul Houq and Muslim Amin, 'The Role of Customer Satisfaction to Enhance Customer Loyalty', (2010), p.2391

<sup>112</sup> Ibid.

<sup>113</sup> Ibid.

### **(iii) Information asymmetries**

Another rationale for banking regulation is to avoid information asymmetries. Information asymmetries can cause market inefficiency in terms of outcomes and choices.<sup>114</sup> The nature of information asymmetries is that the financial market may under-produce relevant information because 'information's public goods nature can make it difficult for those investing in better and new information to appropriate an adequate financial return.'<sup>115</sup> Information asymmetries cause two main problems: adverse selection and moral hazard.<sup>116</sup>

Adverse selection is the problem created by asymmetric information before the transaction occurs. It arises when the potential borrowers who are most actively seeks out loans generally have private information (regarding their personal attributes and prospects of borrowing) which is more accurate than the information possessed by the lender (bank).<sup>117</sup> The lender (bank) would be at a disadvantage with regards to the asymmetric information. Lack of efficiency in terms of the borrowing evaluation can happen due the asymmetric information. Adverse selections can increase the probability that bad credit risks will get loans. As a consequence, lenders may decide not to give any loans, even to good credit risks.<sup>118</sup> Whereas moral hazard represent 'a situation where the prospect of compensation to cover risks and losses increases the likelihood and size of the

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<sup>114</sup> Cento Veljanovski, 'Economic Approaches to Regulation' in Robert Baldwin, Martin Cagé, Martin Lodge, *The Oxford Handbook of Financial Regulation*, (2010), p.21-22

<sup>115</sup> Ibid.

<sup>116</sup> Ibid.

<sup>117</sup> Frederick S. Mishkin, *The Economics of Money, Banking, and Financial Markets*, (2007), p.186

<sup>118</sup> Khadidja Khaldi and Amina Hamdouni, 'Islamic Financial Intermediation: Equity, Efficiency and Risk', (2011), p.148

losses because risky behaviour cannot be monitored and priced appropriately, and excessive losses are compensated.’<sup>119</sup>

A notable example of the information asymmetry and moral hazard problem can be seen in the unrestricted Mudaraba contract where the investment deposits’ capital value and rate of return is not guaranteed. This type of PLS contract represent the circumstances where the ‘Islamic bank manages depositors’ fund at their own discretion.’<sup>120</sup> This contract may become an incentive for bankers to take excessive risk and to fund the operation of Islamic financial institutions without adequate capital without the knowledge of the depositors. An appropriate banking regulation, therefore, that can reduce the information asymmetry problems (which focuses on the clear and concise disclosure of key data and information) inherent in unrestricted Mudaraba contracts may allow depositors to have more options for choosing an ideal bank for investment according to risk preferences. <sup>121</sup>

While the definition of information asymmetry and example above shows that financial institution may conceal certain important information to investors, however, it can be argued that information asymmetry may also happen to Islamic banks as a result of the PLS modes of financial intermediation. For example, the PLS modes of Islamic financial intermediation such as Mudaraba or Musharaka exposes Islamic banks to a

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<sup>119</sup> Supra, Note. 114

<sup>120</sup> V.Sundarajan and Luca Errico, ‘Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead’, (2002), p.6

<sup>121</sup> Ibid., p.12

high degree of asymmetry information.<sup>122</sup> The element of adverse selection exists in the equity-based financial contracts where borrowers have more information on the quality of the project than the Islamic bank. In other words, individuals have incentives to under-state the actual profit they made. Moreover, the fact that in most Islamic financial contracts is partnership based contract, the focus on information asymmetry issue is crucial for the stability of the Islamic banks as well as for the depositors' / investors' protection.

#### **(iv) Systemic stability**

Aside from information asymmetries, the insolvency of financial institutions could trigger systemic instability. This is mainly due to the fact that 'the financial system is subject to waves of confidence' and regulation is necessary to prevent banking panics.<sup>123</sup> As a result, widespread panic deposit withdrawals or runs on individual banks can ultimately cause a systemic crisis through a domino effect.<sup>124</sup> Banking regulation helps to promote systemic stability by maintaining an orderly payments system, ensuring the soundness and stability of the financial system as well as fulfilling depositors' demand.<sup>125</sup>

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<sup>122</sup> Ibid.

<sup>123</sup> Michael Buckle and John Thompson, *The UK Financial System: Theory and Practice*, (1998), p.367

<sup>124</sup> Diamond and Dybvig, (1983) quoted in Andy Mullineux, 'Governing Banks: A British Perspective' (2011), p.3

<sup>125</sup> Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A comparative look at the United Kingdom and Malaysia*, (2011), p.154



It has been argued that since the UK's Islamic banks share the same interbank market with the conventional banks, Islamic banks will be affected by market imperfections from the same financial system.<sup>126</sup> Indeed, an example is the case of the former Islamic Bank of Britain (IBB) where it is reported that the illiquidity of the bank was much affected by the recent financial crisis.<sup>127</sup> While the argument is tenable, the facts show that the illiquidity of IBB since its first year of operation did not trigger a systemic crisis.<sup>128</sup> Arguably, the main reason why IBB's illiquidity did not cause a systemic crisis is because IBB was rather small in the context of the UK financial system.

The former IBB's case further supports Llewellyn's contention that 'systemic issues do not relate to all institutions.'<sup>129</sup> Only if the institution is large or prominent could it trigger banking panics that potentially affect the economy as a whole.<sup>130</sup> Based on the Financial Stability Board interpretation, there are three factors which are taken into consideration as systemically important for financial institutions. These are: their size, complexity and systemic interconnectedness and the existence of these three factors would 'cause significant disruption to the wider financial system and economic activity.'<sup>131</sup>

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<sup>126</sup> Ibid.

<sup>127</sup> Islamic Bank of Britain Annual Report 2012

<sup>128</sup> Ibid.

<sup>129</sup> Supra, Note. 107

<sup>130</sup> Governor Kelly of the Federal Reserve Board quoted in Llewellyn, Supra, Note 15., p.9

<sup>131</sup> Financial Stability Board, 'Policy Measures to Address Systematically Important Financial Institutions (2011) via <<http://www.financialstabilityboard.org/>> accessed: 10 June 2014

With regards to the market size of the Islamic financial sector in the UK, there is no empirical evidence to show the actual size of the sector in comparison with the conventional financial sector. It is, however, reported that Islamic financial assets in the UK as at the end of 2011 show that the UK's Islamic financial sector holds only one per cent out of total Islamic financial assets globally<sup>132</sup> and recent reports have revealed that the UK's Islamic financial assets have reached USD 19 billion.<sup>133</sup> Based on the existing facts, it can be argued that the size of the Islamic banking market in the UK and globally is relatively small. The facts also suggest that it is most likely that there is a low probability of a systemic occurrence. Additionally, the illiquidity of most Islamic banks and Islamic windows operating in the UK during the past ten years support the argument that Islamic banks in the UK are unlikely to cause a systemic crisis.<sup>134</sup> On top of that, based on the list of Global Systemically Important Banks (G-SIBs) issued by the Financial Stability Board; it is found that none of Islamic banks are on the list.<sup>135</sup>

In terms of credit risk, previous research has found that Islamic banks have lower credit risk than conventional banks - especially small, highly-leveraged Islamic banks.<sup>136</sup> Similarly the researchers found that in terms of insolvency risk, 'small

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<sup>132</sup> UK Islamic Finance Secretariat, Report: 'Islamic Finance', (October 2013)

<sup>133</sup> The CityUK, 'Islamic Finance 2013', via <<http://www.thecityuk.com/research/our-work/reports-list/islamic-finance-2013/>> accessed: 15 June 2014

<sup>134</sup> Data from Bankscope database shows that from the year 2008 to 2012, Islamic banks in the UK are facing losses in each year. However, some reservation has to be placed in terms of the data due to the fact that not all banks are listed every year in Bankscope database.

<sup>135</sup> As at 2013, there are 29 G-SIBs listed by Financial Stability Board as systemically important institutions via <[http://www.financialstabilityboard.org/publications/r\\_131111.pdf](http://www.financialstabilityboard.org/publications/r_131111.pdf)>

<sup>136</sup> Pejman Abidefar, Philip Molyneux and Amine Tarazi, 'Risk in Islamic Banking', (2012), p.37 (As have been discussed in chapter two, the research was made using a sample taken from 553

Islamic banks also appear to exhibit greater stability than conventional banks, as they are more capitalised.<sup>137</sup> They continue to suggest that 'in terms of loan quality, (implicit) interest income and (implicit) interest expense, Islamic banks are less sensitive to domestic interest rates compared to conventional counterparts.'<sup>138</sup> The results of their findings, however, have also shown that 'the sensitivity of Islamic banks' solvency position to interest rates is not significantly different from that of their conventional counterparts' and there is no significant difference between large Islamic and conventional banks.<sup>139</sup>

In support of the above findings, an earlier empirical analysis of 77 Islamic banks and 397 conventional banks in 21 countries (predominantly Muslim countries) between the years 1993 to 2004 used a Zscore model to show that small Islamic banks tend to be financially stronger than small conventional banks.\*<sup>140</sup> It is also observed that large conventional banks tend to be financially stronger than large Islamic banks and small Islamic banks tend to be financially stronger than large Islamic banks. The findings of the analysis were based on different variables such as bank size, the structure of the balance sheet and system-wide variables. The analysis suggests that Islamic banks are relatively more stable when operating on a small scale, while they are less stable when operating on a larger scale. It is,

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conventional and Islamic banks from 24 countries (predominantly Muslim countries) between the years 1999 and 2009 using a Zscore model.)

<sup>137</sup> Ibid., p.38

<sup>138</sup> Ibid.

<sup>139</sup> Ibid.

<sup>140</sup>\* Note that this analysis has been discussed earlier in chapter two. Martin Čihák and Heiko Hesse, 'Islamic Banks and Financial Stability: An Empirical Analysis', (2008), p.20

therefore, contended that as Islamic banks become larger, the more complex it becomes for Islamic banks to adjust their credit risk. The researchers further argue that one of the possible explanations for this is the concentration on investment scale where 'small Islamic banks tend to concentrate on low-risk investments and fee income, while large Islamic banks do more PLS business.'<sup>141</sup> The research also concluded that there is no significant impact from a bigger presence of Islamic banks on the soundness of other banks in a country's financial system.<sup>142</sup>

The above findings have shown the stability of Islamic banks in comparison with conventional banks. It is found that small Islamic banks tend to be more stable than small conventional banks and there is no significant difference between large Islamic banks and conventional banks. Earlier, the lack of liquidity of IBB also proved that systemic crisis is not necessarily triggered by the poor performance of a UK Islamic bank. There is, therefore, insufficient evidence to prove that failure of Islamic banks cause systemic crisis.

While in reality, there is stronger evidence to show that Islamic banks do not pose systemic crisis risks, however, systemic instability may still occur. This is because, in theory, the banking system is exposed to a domino effect. Banking regulation is, therefore, still needed to prevent future failures. As Llewellyn states:

"The probability that the failure of a single bank will induce a systemic problem may be low, but, if systemic failure were to occur, it could be serious and the costs could

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<sup>141</sup> Ibid., p.21

<sup>142</sup> Ibid.

be high. Thus, regulation to prevent systemic problems may be viewed as an insurance premium against a low –probability occurrence.”<sup>143</sup>

His argument is reasonable. Nevertheless, while regulation can be regarded as an ‘insurance premium’, the question remains whether more regulation is needed for Islamic banks when the market size of Islamic finance in the UK is relatively small. This is because systemic crisis only happens to systemically important institutions and not to a small market sector.<sup>144</sup> On the other hand, such issues are not separate from the regulators desire to have level-playing-field regulations for the Islamic financial sector.

This section has highlighted the objectives and rationale of banking regulations. The next section focuses on whether simple or additional regulation is more desirable for the regulatory framework of Islamic banks and examines the impact of the existing regulation for Islamic banks on the level-playing-field objective.

## **2.3 ARGUMENTS ON BANKING REGULATIONS**

### **2.3.1 ‘More regulation’ Argument**

#### ***(i) Bank’s prudential as justification for more regulation***

Banking regulations are used to mitigate the risk of the macro and micro prudential aspects of banking institutions. The objective of macro prudential regulation is ‘to limit the risk of episodes of financial distress with significant losses in terms of the

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<sup>143</sup> Supra, Note. 103, p.9

<sup>144</sup> Avinash Persaud, ‘Macro-Prudential Regulation’, (2009), p.6

real output for the economy as a whole',<sup>145</sup> whereas micro prudential regulation is 'to limit the risk of episodes of financial distress at individual institutions, regardless of their impact on the overall economy.'<sup>146</sup>

Due to the unique nature of Islamic banking intermediation, Islamic banks are exposed to risks that require appropriate prudential regulations for the survival of the Islamic financial sector, for instance, credit risk and operational risk.<sup>147</sup> Authors have argued that Islamic banks are more vulnerable to credit risk due to the PLS business modes.<sup>148</sup> This can be inferred from the following examples taken from a Mudaraba contract. Firstly, in Mudaraba contracts, Islamic banks have no legal means to control the agent-entrepreneur who has the freedom to manage the enterprise according to his best judgment. Islamic banks are, therefore, vulnerable to credit risk if the entrepreneur fails to make profits.<sup>149</sup> In addition, in Mudaraba contracts, the Islamic bank is only entitled to receive the principal of a loan from the entrepreneur at the end of contract if profits are made. If, however, loss is accrued at the end of the contract, the Islamic bank is unable to recover its loan.<sup>150</sup>

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<sup>145</sup> Claudio Borio, 'Towards a Macroprudential Framework for Financial Supervision and Regulation?', (2003), p.2

<sup>146</sup> Ibid.

<sup>147</sup> Luca Errico and Mitra Farahbaksh, 'Islamic Banking Issues in Prudential Regulation and Supervision', (1998), p.31, V.Sundarajan and Luca Errico, 'Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead', (2002), p.4-6

<sup>148</sup> Ibid.

<sup>149</sup> V.Sundarajan and Luca Errico, 'Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead', (2002), p.4

<sup>150</sup> Ibid.,p.5

Besides the credit risk mentioned above, Islamic banks are also vulnerable to operational risk. When PLS modes adopted by Islamic banks, the latter operate internal activities which are not normally performed by conventional banks. For instance, there is the determination of profit-loss-sharing ratios on investment projects with PLS contract. Due to the fact that Islamic banks have less onsite control of the project, this requires more on-going auditing of financed projects and greater internal control is required for Islamic banks. Additionally, the non-standardised nature of Islamic financial products and the lack of efficient Sharia litigation system to enforce Islamic financial contracts may expose Islamic banks to more operational risk.<sup>151</sup>

In another example, the original principle of Islamic banking, which is based on the PLS model, is seldom practiced. For instance, in principle, the bulk of assets should be made of PLS mode – which essentially means uncollateralised equity financing. According to Sundarajan and Errico, however, these assets ‘carry far more risk than those made of non-PLS modes, which are collateralised commercial or retail financial operations.’<sup>152</sup> In principle, therefore, ‘the ratio of riskier assets to total assets should typically be higher in an Islamic bank than in a conventional bank.’<sup>153</sup> In practice, however, it is reported that that Islamic banks only implement a small percentage of PLS modes. Based on data reported by the International Associations of Islamic banks, Musharaka and Mudaraba assets account for approximately 25 percent of Islamic banks’ total assets while the rest are made up of non-PLS modes

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<sup>151</sup> Ibid.p.4

<sup>152</sup> Ibid., p.9

<sup>153</sup> Ibid.

– notably mark-up transactions, leasing and lease purchase transactions typically related to trade financing.<sup>154</sup> It is argued, therefore, that the actual practice of Islamic banks represents more of a hybrid between the paradigm of Islamic banks and conventional banks.<sup>155</sup>

At the international level, the Basel Capital Accords provide a regulatory framework for the prudential regulation of banks globally. In the Core Principles for Effective Banking Supervision, Principle 16 states:

“The supervisor sets prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates. The supervisor defines the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, capital requirements are not less than the applicable Basel standards.”<sup>156</sup>

Although banking supervisors are required to set the appropriate minimum capital adequacy requirements, which reflect the risks that banks undertake, the question arises whether the supervisors consider the nature and risks of Islamic banks while setting the requirements. The Basel Committee is a renowned international standard-

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<sup>154</sup> Ibid.

<sup>155</sup> Luca Errico and Mitra Farahbaksh, ‘Islamic Banking Issues in Prudential Regulation and Supervision’, (1998), p.28

<sup>156</sup> Bank for International Settlements, ‘BCBS Core Principles for Effective Banking Supervision’, (September 2012)



setting body, which helps to improve the quality of banking supervision worldwide. The UK and Malaysia both adopt Basel standards.<sup>157</sup>

Based on the facts presented earlier, while the types of risks are identical to those faced by the conventional banks, nevertheless, Islamic banks address the risks quite differently. The application of Basel Accords may, therefore, not necessarily be the best option for the prudential regulatory framework for Islamic banks. Acknowledging this fact, the Islamic Financial Services Board (IFSB) has enacted an international regulatory framework for Islamic banks worldwide. The IFSB standards aim to complement the work of the Basel Committee to improve the supervisory framework for Islamic banks.<sup>158</sup> While the UK's regulators are aware of the different nature of Islamic banks, nevertheless, the IFSB standards seem to be given less attention by the UK's regulators. There is no emphasis placed on domestic Islamic banks to follow the IFSB standards. As a result, the prudential standards for Islamic banks may not be at the optimum level.

## ***(ii) Sector's development as justification for more regulation***

Regulation can help the Islamic banking sector to develop.<sup>159</sup> Without appropriate prudential regulation that suits the nature of Islamic banks, the sector could potentially be displaced in the financial market. An appropriate regulatory

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<sup>157</sup> Bank for International Settlements, 'BIS Member Central Banks', via <<http://www.bis.org/bcbs/>> accessed: 6 August 2015

<sup>158</sup> Apart from complementing Basel Standards, IFSB also complements the work of the International Organisation of Securities Commissions and the International Association of Insurance Supervisors.

<sup>159</sup> Luca Errico and Mitra Farahbaksh, 'Islamic Banking Issues in Prudential Regulation and Supervision', (1998), p.31

accommodation such as the regulation for the Alternative Finance Bond has indeed allowed the Sukuk market to develop in the UK. Such regulatory accommodation that suits the nature of Islamic finance has in fact attracted investors to purchase a sovereign Sukuk worth £200 million issued by the UK government worth in the year 2014; it was oversubscribed.<sup>160</sup> This development has indeed proved that the rudimentary principle in designing all regulatory or supervisory arrangements is ‘to support and enhance market functioning, rather than to displace market.’<sup>161</sup> Additionally, as mentioned in the earlier chapter, the abolition of double taxation for Islamic financial products<sup>162</sup> could further help the Islamic financial sector to develop its market in the UK and help to achieve the objective of a level-playing field.

### **(iii) Transparency as justification for more regulation**

The UK’s Financial Conduct Authority requires all banking institutions to deliver transparent dealing with their clients. In particular, it states that:

“A firm must pay due regard to the information needs of his clients, and communicate information to them in a way which is clear, fair and not misleading.”<sup>163</sup>

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<sup>160</sup> HM Treasury, News: Government Issues First Islamic Bond via <<https://www.gov.uk/government/news/government-issues-first-islamic-bond>> accessed: 30 June 2014

<sup>161</sup> Douglas W. Arner, *Financial Stability, Economic Growth and the Role of Law*, (2007) (SOAS e-library)

<sup>162</sup> HM Treasury, ‘Government Sterling Sukuk Issuance: A consultation’, ( November 2007), p.9

<sup>163</sup> Financial Conduct Authority Handbook, PRINC.2.1.7

The notion 'must' in the above provision represents the regulator's expectation that institutions behave in a specific way. In particular, banking institutions in the UK are expected to be transparent in their day-to-day dealings with their clients by delivering information which is 'clear, fair and not misleading.'

Owing to the unique nature of Islamic banks, transparency in delivering the information to the clients is significant in preventing market abuse that includes 'insider dealing, market manipulation, money laundering, terrorism financing and corruption.'<sup>164</sup> Transparent regulations serve as an important tool to create market confidence in the banking and financial sector.

The fundamental principle in Islamic banking operations based on the PLS model requires Islamic banks to provide all the necessary information with regard to the model. A notable example which reflects transparent information can be seen in the terms and conditions of the former Islamic Bank of Britain (IBB) to its depositors. As mentioned in the previous chapter, the former IBB has followed the transparency requirement by stating the non-Sharia-compliant aspect of its current account product, in particular, the UK's regulatory policy for the deposit payment guarantee, which runs contrary to the PLS mode.<sup>165</sup>

It is suggested that the lack of clarity in Islamic banking practices require more effective regulation with regard to transparency; because not all aspects of Islamic

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<sup>164</sup> Christine Kauffman and Rolf H. Weber, 'The Role of Transparency in Financial Regulation', (2010), p.4

<sup>165</sup> Islamic Bank of Britain Direct Savings Account Special Conditions, Conditions 8.4

banking operations are based on PLS principles. Recent research suggests that due to the risks and complexities involved in PLS methods, Islamic banks tend to apply non-PLS methods in their short-term financing.<sup>166</sup> Under PLS financing, Islamic banks need to determine the profit or loss ratio for each project. Islamic banks, however, face challenges in quantifying clients' characteristics and proposed business opportunities. Hence, the PLS method seems not to be viable especially for short-term financing. Moreover, revenue is not guaranteed. Additionally, under Mudaraba contracts, 'Islamic banks have limited means to control and intervene in the management of a project.'<sup>167</sup>

Another study shows that Islamic banks mainly use non-PLS instruments to avoid the moral hazard problem associated with PLS financing.<sup>168</sup> With regards to Islamic banking in Malaysia, only 0.5% of finance is based on PLS principles.<sup>169</sup> These studies reveal the need for further investigation with regards to the transparency of information given to customers. Market confidence could be affected when clients are expecting a PLS transaction, but, in reality, a non-PLS model is being used. This issue calls for more robust regulation on transparency for Islamic banks so that it can deliver information that is clear, fair and not misleading. Moreover, the previous chapter has shown that the lack of transparency in Islamic banking contracts has led to the issue of non-Sharia-compliant cases being questioned in a court of law, consequently causing reputational risk.

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<sup>166</sup> Pejman Abidefar, Philip Molyneux, Amine Tarazi, 'Risk in Islamic Banking', (2012), p.10

<sup>167</sup> Ibid.

<sup>168</sup> Ibid.

<sup>169</sup> Ibid.

It can be concluded that the factors outlined above arguing for more regulation amount to one thing – depositors’ protection. While these factors above are inarguable, nonetheless, there are several other factors that suggest that simple regulation may be more appropriate for the regulatory framework for Islamic banks. These factors are considered in the next section.

#### 5.4.2 ‘Less is more’ Argument (Simple Regulation)

##### **(i) Cost-benefit of regulation as justification for simple regulation**

*“As a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit.”<sup>170</sup>*

Regulation imposes costs both on the regulators and the regulated.<sup>171</sup> As Erlich and Posner argues, the costs of regulation can be categorised into four main categories: (i) the fixed (costs) of designing and implementing legal standards (rule-making costs), (ii) the costs of enforcing the standards (enforcement costs), (iii) the costs that they impose on the regulated industry (compliance costs), and the social costs imposed by regulatory offences (harm costs).<sup>172</sup> As such, it can be argued that the costs of regulation can be relatively high and this, therefore, raises the issue of a cost-benefit analysis of regulation. Following this, the justification for simple

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<sup>170</sup> George Stigler (1971:3) quoted in Robert Baldwin, Martin Cage, Martin Lodge, *The Oxford Handbook of Financial Regulation*, (2010), p.10

<sup>171</sup> Cento Veljanovski, ‘Economic Approaches to Regulation’, in Robert Baldwin, Martin Cage, Martin Lodge, *The Oxford Handbook of Financial Regulation*, (2010), p.28

<sup>172</sup> Isaac Ehrlich and Richard A. Posner quoted in Cento Veljanovski, *Ibid.*

regulation represents that principle that the benefit of regulation should outweigh the costs incurred.<sup>173</sup> In the OECD Principles of Good Regulation, one of the principles of good regulation is that regulation should produce benefits that justify costs by taking into consideration the economic, environmental and social effects<sup>174</sup> and it is said that an efficient set of regulations 'minimises the sum (total) of the expected costs (the four categories mentioned earlier) and losses by selecting the most appropriate type of rule, and level and type of enforcement.'<sup>175</sup>

Due to the fact that the making of regulation is connected with economic principles, authors have argued that more regulation leads to complexity in financial structures and systems. For instance, it has been argued by Spatt that regulators should resort to 'relatively simple standards and principles so that market participants can internalise the consequences of their actions.'<sup>176</sup> His argument is supported by Aikman et. al where they contend that 'financial market participants are always likely to seek to game financial regulations, however complex they may be.'<sup>177</sup> They further argue that more complex regulation makes it difficult to identify regulatory arbitrage, whereas simpler regulation may facilitate the identification of regulatory arbitrage.<sup>178</sup>

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<sup>173</sup> Ibid.

<sup>174</sup> Organisation for Economic Co-operation Development (OECD), 'Guiding Principles for Regulatory Quality and Performance', (2005), p.3

<sup>175</sup> Supra, Note. 171

<sup>176</sup> Chester S. Spatt, 'Complexity of Regulation', (2012), p.1

<sup>177</sup> David Aikman, Mirta Galesic, Gerd Gigerenzer, Sujit Kapadia, Konstantinos Katsikopoulos, Amit Kothiyal, Emma Murphy and Tobias Neumann, 'Taking Uncertainty Seriously: Simplicity Versus Complexity in Financial Regulation', (2014), p.22

<sup>178</sup> Ibid.

The question of the utility of regulation is an essential factor for considering the need to have more regulation. The OECD Review on Better Regulation stated that the UK Government gives centrality to regulatory impact assessment (RIA) in its regulatory decision making by assessing the cost, benefits, risks and costs of the proposed regulation. For example, evidence from the RIA for Sukuk shows that the regulatory decisions were made based on the outcome of the regulatory accommodation. This is because the regulators believed that the new regulatory accommodation for Sukuk would bring more benefit to the UK market than the incurred cost.<sup>179</sup>

The justification for simple regulation also lies within the UK's Better Regulation policy through the notion 'Reducing Regulation Made Simple: Less Regulation, Better Regulation and Regulation as a Last Resort.'<sup>180</sup> This notion encapsulates the concept that regulation is considered as a last resort. The approach taken by the UK's regulators is seen to be in line with arguments made by scholars<sup>181</sup> who are pessimistic about the need to have more regulation. Although the UK's Better Regulation framework is primarily aimed at businesses in general (not directly at the financial system); nevertheless banking business is considered to be a part of the business world. The framework, therefore, reflects the government's key priority, which is for less regulation. It is said that regulation:

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<sup>179</sup> HM Treasury, 'Legislative Framework for the Regulation of Alternative Finance Investment Bond (Sukuk)', (2009)

<sup>180</sup> HM Government, 'Reducing Regulation Made Simple: Less Regulation, Better Regulation and Regulation as a Last Resort' (December 2010)

<sup>181</sup> George G. Benston, 'Consumer Protection as Justification for Regulating Financial-Services Firms and Products' (2000), George J. Benston and George G. Kaufman, 'The Appropriate Role of Bank Regulation' (1996), Chris Ford and John Kay, 'Why Regulate Financial Services' (1996)

“can be ineffective in achieving its intended outcomes if its effects on the system as a whole have not been properly considered...If the details of its proposed implementation have not been thought through at the outset, including the costs on the economy and the potential impact of enforcement, the burden of regulation can be much higher than necessary. In fact, hastily conceived regulation may prove to be unenforceable and could, in some cases, be more harmful than doing nothing.”<sup>182</sup>

It can be argued that, although the key factors above motivate the present policy, the point that ‘regulation may prove unenforceable and in some cases, be more harmful than doing nothing’ is disputable. Additionally, can the regulation be made simple when financial diversity is encouraged and ultimately the banks can be exposed to various types of unknown risks stemming from their financial products? The latter issue will not, however, be discussed in this chapter.

In a financial system, therefore, regulation can be said to produce two effects: (i) law can help to prevent negative financial shocks from occurring and (ii) law can help to mitigate the harm from financial shocks after they occur.<sup>183</sup> The question, therefore, remains as to how regulation has proved to be more harmful than doing nothing?

If it is argued that simple regulation is the most practical approach, the question is whether regulatory intervention should be ex-ante or ex-post financial failure? This has led us to the next factor.

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<sup>182</sup> Supra, Note. 180, p.8

<sup>183</sup> Iman Anabtawi and Steven L. Schwarcz, ‘Regulating Ex Post: How Law Can Address the Inevitability of Financial Failure’, (2013), p.92



**(ii) *Ex-ante* and *ex-post* as justification for simple regulation**

The *ex-ante* approach refers to rules and preventive regulation designed to apply before the conduct occurs. *Ex-ante* operation is resolved in advance of the targeted activity.<sup>184</sup> On the other hand, '*ex-post* measures tend to be associated with standards or litigation.'<sup>185</sup> As opposed to rules, standards or litigation do not represent how or what constitute permissible conduct.<sup>186</sup> *Ex-post* content is determined 'after the conduct to which it applies has taken place.'<sup>187</sup>

It has been argued that achieving the right balance of *ex ante* and *ex post* regulation remains a challenge. This is because, both *ex ante* and *ex post* have their own limits. Anabtawi and Schwarz listed three limits of *ex ante* financial regulation. First, financial crisis will still happen due to the incomplete information that occurs within the financial system. They describe this as 'normal accidents' that often happen in the financial world, where despite preventive measures, financial crisis still happens. Complete *ex ante* regulation could not, therefore, prevent financial crisis. Indeed, as argued by Anabtawi and Schwarz; the belief that regulation can prevent every failure is an unrealistic goal.

Secondly, the political economy of financial regulation entails the political influence of the financial services industry. The industry 'plays an important role in explaining

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<sup>184</sup> Ibid.

<sup>185</sup> Ibid.

<sup>186</sup> Ibid.

<sup>187</sup> Ibid.

the accumulation of risk in an economy'.<sup>188</sup> They further argue that public choice theories of regulation influence the production of regulation in terms of various factors and the regulatory process. The various factors also include the industries being regulated and the public sentiment.<sup>189</sup> Indeed, creating a separate regulatory framework for Islamic finance in the UK may not be suitable for the secular nature of the state, as opposed to Malaysia where Muslims are the majority society of the state. In the latter case creating a state regulatory framework for Islamic finance is acceptable.

Thirdly, tight *ex ante* regulation can also result to circumvention and lead to regulatory arbitrage. Moreover, tight *ex ante* regulation also leads to other unintended consequences. For example, extreme risk aversion would result in certain investment opportunities being rejected.<sup>190</sup>

As complete *ex ante* regulation could not be the sole approach to financial regulation, it has been argued that *ex post* regulation would complement the limits of *ex ante*.<sup>191</sup> For instance, the fact that financial failure happens in this complex financial system, *ex post* regulation is required to address those inevitable failures and it is needed to respond to the consequences of risk taking.<sup>192</sup>

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<sup>188</sup> Ibid., p.96-97

<sup>189</sup> Ibid., p.97

<sup>190</sup> Ibid.

<sup>191</sup> Ibid., p.102

<sup>192</sup> Ibid.

However, complete *ex post* regulation can give rise to moral hazard. Moral hazard occurs when 'a decision maker is incentivised to take risks beyond the level that he or she would have otherwise taken because some or all of the negative consequences of taking those risks are shifted to third parties.'<sup>193</sup> The establishment of safety nets would encourage market participants to take excessive risks because they believe that they are protected. This encouragement ultimately increases the fragility of the financial system. Additionally, excessive *ex post* regulation could also burden taxpayers. The failure of firms or markets could potentially lead to the use of taxpayers' funds.<sup>194</sup>

While complete *ex ante* or *ex post* regulation has its limits, it is suggested that aiming for the right balance between these two types of regulation can be regarded as an appropriate strategy to protect the financial system. Although it is difficult to determine the right balance, nevertheless, Anabtawi and Schwarz suggests three factors that can be taken into consideration in choosing the optimal mix of *ex ante* relative to *ex post* regulation: (i) the predictability of financial crisis (ii) the feasibility of adopting financial regulation and (iii) the ability of regulators to implement their programmes without giving rise to substantial market inefficiencies or regulatory arbitrage.

With regards to Islamic banks in the UK, as mentioned in the earlier section, the lack of liquidity of the biggest Islamic bank in the UK (the former Islamic Bank of Britain) proved that financial crisis does not happen. Secondly, there is not yet a

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<sup>193</sup> Ibid., p.122

<sup>194</sup> Ibid.,p.125

feasibility study on the impact of more regulation on Islamic retail banks. It is, however, likely that more regulation for retail Islamic banks would not have any major impact on the performance of Islamic banks - although the existing conventional regulatory framework, which governs Islamic retail banking, does affect the Sharia-compliant aspect of depositors' investments. As argued in the previous chapter, the existing regulatory framework does not provide an opportunity for the Deposit Guarantee Scheme fund to be invested in a Sharia-compliant way. Additionally, so far, there is no case which proves that the existing regulatory framework governing Islamic banks both at the retail and wholesale level affect market efficiencies substantially or cause regulatory arbitrage.

### **(iii) Buy what you understand as justification for simple regulation**

It has been argued that the main justification for the regulation of financial services firms and products is to protect retail consumers. This fact has been debated by George J. Benston. In his work, Benston referred mainly to Llewellyn's analysis on the rationale of regulation. Llewellyn argues that market imperfections and failures are justifications for regulation and regulation is important so that consumers are protected. The factors that he pointed out for regulation are:

“Problems of inadequate consumer information, problems of asymmetric information, the difficulty of ascertaining the quality of financial contracts at the point of purchase; imprecise definitions of products and contracts; under investment in information by consumers....agency costs and potential principal-agent problems and issues related

to conflict of interest and, because of the technicalities of some financial products, consumers are not equally equipped with an ability to assess quality, etc.”<sup>195</sup>

While Llewellyn’s justification for regulation is regarded as the main rationale for regulating financial products and services, Benston contended that retail financial products are similar to non-financial products and services. For instance, the purchasers of television sets, automobiles, refrigerators and computers have inadequate information about the products they buy, for example, how the product was manufactured, the time when specific parts might fail, the cost of repairing the unit, etc. Thus they are experiencing asymmetric information as they know less than the manufacturers. Moreover, Benston added that consumers often equipped with the ability to evaluate all the products, would probably rely most on other consumers’ reviews. Therefore, Benston in his cynical remark argues that:

“...neither Llewellyn nor anyone else would want the government to establish the Consumer Appliance Authority or Home Maintenance and Repair Authority to deal with the economic problems faced by consumers of these financial and non-financial products. Rather, it would or should look to competition among suppliers and other market forces to solve the problems.”<sup>196</sup>

Benston suggests an interesting point – retail consumers should not buy what they do not understand; so that their lack of understanding of the product they wish to consume will not do harm to their economy. For consumers who wish to purchase

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<sup>195</sup> Quoted in George J. Benston, ‘Consumer Protection as Justification for Regulating Financial-Services Firms and Products’ (2000), p.288

<sup>196</sup> Ibid., p.289

financial instruments that offer great profits, the duty rests with the producer of the instrument (bank) to reduce the consumers' costs by providing what information consumers' want. He further argues that often the optimal amount of information and quality of information will be provided to consumers voluntarily.

Using Benston's argument with regards to Islamic bank depositors, the latter should not deposit their money if they do not understand the nature and risks associated with the Islamic banking system (although it can be argued that deposit taking in retail banking does not pose many issues to depositors. because they are covered by Deposit Protection Scheme). Similarly, with regards to other investment products; investors with Islamic banks should not invest in a product with which they are not familiar.

Benston's argument is also attractive when the duty to provide information rests upon the provider of the instrument (the bank). This argument is, however, attractive only to a certain extent. Benston's reference to the consumption of non-financial products cannot be totally equated with financial products. This is because the effect of market failure arising from non-financial products and financial products is not the same. Market failure arising from non-financial product does not cause a 'company run' like a 'bank run'. Arguably, what most consumers of non-financial product would do is to stop purchasing the same brand the next time around. The situation for consumers of financial products, both depositors and investors, is very different. The non-performance of banks could result in a bank run, which ultimately has a potentially contagious effect. As a consequence, this could cause a financial crisis if the bank is a systemically important institution.

This is not to say that there should be no regulation at all for financial products (unlike Benston's argument that regulation is neither necessary nor desirable to serve other goals); there should be an adequate amount of regulation that is enough to serve the objectives of banking regulation. Moreover, regulation is necessary for some banking products, which could expose depositors or consumers to some risks. An appropriate regulation for Islamic banks is essential to protect the need of investors who are looking for ethical investment.

**(iv) Platforms for dispute resolution as justification for simple regulation**

When dispute arises due to the lack of regulation or regulatory loopholes, there are several available platforms that the parties can choose to settle their disputes. These are: (a) Sharia Supervisory Boards (b) Arbitration and Mediation (c) an Ombudsman and Courts of Law.

**(a) Sharia Supervisory Board (SSB)**

In the previous chapter, the function of the Sharia Supervisory Board in an Islamic bank was mentioned. As noted earlier, the UK's level-playing field regulations have no specific regulation pertaining to the role of an SSB. It is mentioned that the function of an SSB is merely advisory. In Malaysia, however, the SAC has power over the SSB of an Islamic bank. Disputes unsolved at the SSB level can be brought forward to the SAC. While an SSB does not have the power to issue a

fatwa unlike the Sharia Advisory Council<sup>197</sup>, nevertheless, any advice sought from an SSB pertaining to the Sharia-compliant aspect of the contract in the UK's Islamic banks may resolve disputes encountered between the Islamic bank and the customer.

## **(b) Arbitration and mediation**

Arbitration and mediation is another method for setting disputes among parties affected. Arbitration is defined as:

“A non-court alternative method of resolving disputes where a neutral, independent arbitrator or panel of arbitrators, known as a tribunal, is appointed by a third party to make a binding decision, known as an award, from which there are very limited grounds of challenge.”<sup>198</sup>

Mediation is another form of dispute resolution, which is ‘a flexible process conducted confidentially in which a neutral person (the mediator) actively assists parties in working towards a negotiated agreement of a dispute or difference.’<sup>199</sup> The process of mediation can be before or after the arbitration. In mediation, the mediator cannot issue any binding award or judgement unlike in arbitration. Med-Arb is another form

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<sup>197</sup> Rusni Hassan, Nurdianawati Irwani Abdullah, Aznan Hassan, Uzaimah Ibrahim, Mohd Fuad Md. Sawari, Akhtarzaite Abd. Aziz, Agus Triyanta, *A Comparative Analysis of Sharia Governance in Islamic Banking Institutions Across Jurisdiction*, (2013), p.17. Sharia Advisory Council – an independent highest authority of Sharia supervisors formed by the Central Bank of Malaysia. IFSB-10, Principle 3: IFSB Guiding Principles on Sharia Governance Systems for Institutions Offering Islamic Financial Services.

<sup>198</sup> Jonathan Lawrence, Peter Morton and Hussain Khan, ‘Resolving Islamic Finance Disputes’, (2013), p.3

<sup>199</sup> Ibid., p.7



of dispute resolution which is 'a hybrid between both mediation and arbitration' where parties can resort to both platforms for dispute settlement.'<sup>200</sup>

Several international arbitration treaties such as United Nations Commission on International Trade Law (UNCITRAL) and the New York Convention Arbitration Treaties are adopted by hundreds of countries as the basis for their arbitration processes.<sup>201</sup> Both the UK and Malaysia are member states to both conventions.<sup>202</sup> Other available platforms for arbitration in Islamic finance include the Kuala Lumpur Regional Centre for Arbitration (KLRC), the Asian-African Legal Consultative Organisation (AALCO), the Dubai International Arbitration Centre (DIAC), the Abu Dhabi Commercial, Conciliation and Arbitration Centre (ADCCAC) and the International Islamic Centre for Reconciliation and Commercial Arbitration (IICRCA).

Opting for arbitration could be a practical approach to resolving Islamic finance disputes as compared to choosing litigation for several reasons. First, the decision is based on the parties' choice of law. This has been affirmed in the English Arbitration Act 1996 which states:

"If the parties so agree, in accordance with such other considerations as are agreed by them or determined by the tribunal."<sup>203</sup>

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<sup>200</sup> Andrew Tweeddale and Keren Tweeddale, *Arbitration of Commercial Disputes, International and English Law Practice*, (2007), p.24

<sup>201</sup> *Ibid.*, p.39

<sup>202</sup> UNCITRAL, via <[http://www.uncitral.org/uncitral/about/origin\\_history.html](http://www.uncitral.org/uncitral/about/origin_history.html)> , New York Arbitration Convention via <<http://www.newyorkconvention.org/>> accessed: 30 May 2014

<sup>203</sup> Section 46 of Arbitration Act 1996

Secondly, the choice of arbitration could avoid the lengthy and rigid process in litigation. It has been said that arbitration 'is a cheaper and quicker method of dispute resolution'.<sup>204</sup> Such perception, however, very much depends on how the arbitration is conducted.<sup>205</sup>

Moreover, arbitration is arguably a better platform for dispute resolution because an expert in Sharia and commercial transactions can become the arbitrator for the parties. The parties also have the liberty to choose the desired arbitrator or arbitrators to handle the dispute resolution process. Whereas in litigation, often that courts' judges have limited knowledge in the Islamic financial industry and may incur more time to seek an expert opinion.<sup>206</sup>

While decision making in arbitration is based on the agreement of the parties, there is a possibility that the issue of the Sharia-compliant aspect may differ from one arbitrator to another. This may cause uncertainties and lack of standardisation in Islamic finance disputes as the decision made by arbitrator is not released publicly unlike in litigation. Since the decision is made on a close case basis, the Sharia-compliant aspect of a transaction may be regarded as Sharia compliant, while it is not by other decision makers. It can, therefore, be argued that reference to a court of law can promote better transparency. On the other hand, some may also argue

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<sup>204</sup> Supra, Note. 655

<sup>205</sup> Ibid.

<sup>206</sup> Ibid.

that as long as the decision made is agreeable between parties, the concern of the above should not be an issue.

**(c) *Ombudsman and courts of law***

When there is a lack of regulation or issues pertaining to Islamic banking, other platforms can be resorted to such as an ombudsman and litigation. In the UK, the Financial Ombudsman Service provides a platform for consumers to report issues with regards to their transactions with banks, insurance or financial firms with which they are dealing. The ombudsman service is similar to mediation and in certain cases, the ombudsmen has the power to make decisions for the parties. Since the Financial Conduct Authority (FCA) approval of Islamic finance Home Purchase Plans, this Islamic mortgage product has been included within the remit of the UK's Ombudsman Service.<sup>207</sup>

Finally, issues pertaining to Islamic banks can be brought before a court of law. The reported cases mentioned in the earlier chapters have shown that Islamic banks' customers have resorted to litigation and it is observed that Islamic banking cases were solved by the court like any other contractual cases. While it is often the Sharia-compliant aspect of a contract that was one of the grounds of the dispute, nevertheless, it is be observed that the reported cases (mentioned in the previous chapters) show no compelling argument to have more regulation for Islamic banks.

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<sup>207</sup> Financial Ombudsman Service, News: 'The Head Ruling the Heart', via  
<<http://www.financialombudsman.org.uk/publications/ombudsman-news/59/59.pdf>> accessed: 20  
May 2014

## **(v) Societal background as justification for simple regulation**

### **(a) The United Kingdom**

The societal background of a state is an important factor for a particular regulatory policy. With regards to the issue of a regulatory framework for Islamic banks in the UK, one of the justifications for simple regulation is to look at it from the societal background perspective. In a secular society, the separation between the state and the church dictates that the opinion of the religious leader should not change the very nature of the state's practice. For instance, the Archbishop of Canterbury, Rowan Williams, who suggested that the UK government should provide some legal accommodation for certain Sharia matters especially for family laws - did not have much impact on secular society.<sup>208</sup>

Secular society represents the neutral aspect or generalisation in the law that represents the divorce between religious belief and the state's law. As such, the religious belief inherent in what is deemed to be Sharia compliant has no impact on secular society. In fact, what is expected by secular society is that Islam and any other religion should accept the law as it is.<sup>209</sup> In short, the community has to subsume its religious culture and belief into secular society – the law of the land is

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<sup>208</sup> Archbishop's Lecture - Civil and Religious Law in England: a Religious Perspective', (7 February 2008) via <<http://rowanwilliams.archbishopofcanterbury.org/>> accessed: 21 August 2015. See, 'Civil and Religious Law in England: A Religious Perspective via <<http://www.theguardian.com/uk/2008/feb/07/religion.world2>> accessed: 10 July 2015

<sup>209</sup> Nicholas Phillips, 'Equal before the Law' in Robin Griffith-Jones (ed), *Islam and English Law*, (2013), p. 291

the English law. Religions may practice their belief freely as long as it does not contravene to English law. Former Lord Chancellor Jack Straw commented:

“...there is nothing whatever in English law that prevents people abiding by Sharia principles if they wish to, provided they do not come into conflict with English law.”<sup>210</sup>

While the Islamic financial system is well accepted by the UK government, secular society may not be able to accept fully the legal accommodation especially made for the Islamic financial sector. The fact that the sector is considered as an emerging sector globally, nevertheless, the regulators are expected to consider the sensitivity of the society in making regulatory policies. This is because, the society is the consumer in an economy, and their money is used (tax) for regulatory policy making. Thus, it can be argued that by simply creating more regulatory accommodation for Islamic finance without proper justification may cause an issue. Although on the one hand the secular nature of the state *per se* dictates how much attention is given to the regulatory governance of Islamic financial sector, on the other hand, the existing antipathy towards Islam itself could be a factor, especially post the 9/11 incident. It can be argued that due to these factors, matters that are associated with Islam could be seen as an effort to Islamise the UK.

Nevertheless, the suggested factors are not supported by any empirical evidence. There is no research thus far that has proved a lack of acceptance level by secular society for greater regulatory accommodation for the Islamic financial sector.

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<sup>210</sup> Lord Chancellor Jack Straw quoted in Ian Edge, Development towards Legal Pluralism?’ in Robin Griffith-Jones (ed), *Islam and English Law* (2013), p.118-119

Moreover, the differences in Sharia practices in Islam add to the complexity of making a separate regulatory accommodation for Islamic financial services. The various Sharia practices derived from the Maliki, Hanbali, Hanafi and Shafie schools of thoughts within the religion itself lead to the impossibility of accommodating Sharia principles. In fact, looking at the wider picture, the religion of Islam is divided between the Sunni and Shia sects, which hold different sets of beliefs and this further complicates the application of Sharia principles. The Muslims in the UK, who migrated from various countries, have applied different sets of Sharia practices in their daily life. As a result, the daily Sharia practice within the UK's Muslim community could be more restrictive than that which is actually practiced in the country of origin whence the Muslim migrant came. As Ian Edge argues:

“The Sharia rules applied by the different Muslim communities among themselves in the unreformed traditional rules of Sharia which are almost nowhere applied in the Islamic world because important reforms and amendments (at least in personal status matters) have become almost universal. The Sharia rules applied by Muslim communities in the UK therefore may be more conservative and restrictive than those currently applied in the Islamic countries from which Muslim immigrants to the UK have migrated.”<sup>211</sup>

Referring to the above argument, it is indeed arguable that the different sets of beliefs within the religion itself could lead to a tougher Islamic practice. In this regard, if the regulations of Islamic banks are formulated on a more restrictive

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<sup>211</sup> Ibid., p.141

basis, it would have been more difficult to develop the sector in a secular state such as the UK.

It can, therefore, be suggested that the existing legal accommodation is designed mainly to generate the economic development of the state. That is, to attract more investments from the Gulf region. However, the UK being one of the top financial centres in the world, their involvement in Islamic finance is seen as being driven by the rapid demand for Islamic finance globally and hence this sparked the interest of the government in being the global hub for Islamic financial services. The ambition to be the global hub for Islamic finance arguably represents the government's acceptance of this type of financial service and it is seen as an effort to strengthen its identity as the global financial centre.

### **(b) Malaysia**

While both the UK and Malaysia have the same mission, to be the global hub for the Islamic financial sector, nevertheless, it can be argued that having more regulatory accommodation for the sector in Malaysia is seen to be more acceptable in society. One possible factor is the fact that Malaysia is an Islamic majority country. Islam is the largest religious group in the country with 60 per cent of the population being Muslim and the remaining 40 per cent being non-Muslims.<sup>212</sup>

As mentioned in the previous chapter, Malaysia adopted a dual regulatory framework to treat the Islamic and the conventional financial services on a level-playing field

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<sup>212</sup> Muslims in Malaysia is practicing Shafie school of thought. Malaysia Demographics Profile 2013 via <[http://www.indexmundi.com/malaysia/demographics\\_profile.html](http://www.indexmundi.com/malaysia/demographics_profile.html)> accessed: 10 June 2014

(despite the argument earlier that at some point the Central Bank of Malaysia gives greater attention towards the development of the Islamic banks than conventional banks).

It can be suggested that the implementation of the dual regulatory framework is due to several factors. Firstly, the government has made the effort to redefine the Malays in Malaysia as 'Melayu-Baru', which literally means the New Malays. In this regard, Malays, who are all regarded as Muslims, are people who have a personality that is suitable to the changing times and at the same time demonstrate the necessary attributes of a good Muslim. For the New Malays, 'religion would not in any way become an obstacle to economic progress.'<sup>213</sup> Thus, the Islamic financial sector reflects the newly modern Muslim culture for the financial sector and a factor that contributes to the economic progress of Malaysian society - although it could be inferred that the consumption of Islamic finance is still considerably lower than the consumption of conventional financial products.<sup>214</sup>

Secondly, the former Prime Minister Mahathir Mohammad introduced a national agenda to make Malaysia a fully developed country by the year 2020 through 'Vision 2020'. One of the features of Vision 2020 is 'the challenge of establishing a prosperous society, with an economy that is fully competitive, dynamic, robust, and resilient' and 'the challenge of ensuring an economically just society... a society in which there is a

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<sup>213</sup> Abu Bakar Abdul Majeed, 'Malaysia: Truly Asian and Rightly Islamic' in Ibrahim Abu Shah (ed), *Islam Democracy and Good Governance – The Malaysian Experience*, (2004), p.75

<sup>214</sup> Ching Wing Lo and Chee Seng Leow, 'Islamic Banking in Malaysia: A Sustainable Growth of The Consumer Market', (December 2014), p.527



fair and equitable distribution of the wealth of the nation, in which there is full partnership in economic progress.’<sup>215</sup>

As such, while several matters in Malaysia are not wholly Islamic (especially in regards to civil or criminal matters) and where Sharia law is not fully implemented, the greater emphasis on promoting the Islamic financial sector is arguably to create a national identity for Malaysia. Vision 2020 and the Malaysian New Economic Policy (NEP)<sup>216</sup> during Mahathirism reflect his ambitious plan to bring Malaysia to the world stage. His aim of making Malaysia the ‘model Islamic state’ could arguably be regarded as one of the reasons why Malaysia is focusing on Islamic finance and the concept of a ‘just economy’ of Islamic finance seems to blend well with the Vision 2020 agenda. The evidence above also demonstrates that the Malaysian government and society is more open to developing an emerging sector that could boost the Islamic nature of the country.

#### **(vi) Other international regulatory standards as justification for simple regulation**

While the earlier discussions have highlighted the fact that there is a lack of regulatory accommodation for Islamic banks in the UK, this issue may possibly be resolved, without having more regulatory accommodation, through adopting international regulatory standards for Islamic financial institutions. It can be argued

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<sup>215</sup> ‘Malaysia as a Fully Developed Country’, via <<http://www.wawasan2020.com/vision/p2.html>> accessed: 15 May 2014

<sup>216</sup> ‘Economic Planning Unit’, via <<http://www.epu.gov.my/en/>> accessed: 15 May 2014

that the need for more regulatory accommodation for Islamic banks in the UK is reduced by implementing international regulatory standards devised by bodies such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB). These establishments aim to complement the existing international regulatory standards such as the Basel Accords, which focus on the conventional financial sector.

AAOIFI issues standards in accounting, auditing, governance, ethics and Sharia standards for Islamic financial institutions,<sup>217</sup> while the IFSB issues international standards that 'promote and enhance the soundness and stability of the Islamic financial services industry'.<sup>218</sup> In the UK, Islamic banks are encouraged to follow the AAOIFI and IFSB standards; nevertheless, it is not obligatory for Islamic banks to comply with these standards.<sup>219</sup> The non-obligatory nature of these standards may lead to a lack of quality in international standards for Islamic banks. This may also lead to the lack of a level-playing field for Islamic banks as regulators appear to focus more on conventional regulatory standards. Simple regulation may, therefore, be the desirable option for regulating Islamic banks in the UK, while at the same time incorporating the published international standards into the existing regulatory framework. Issues pertaining to the lack of regulation for Islamic banks could be minimised without having to resort to more regulatory enactment of the domestic legislation.

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<sup>217</sup> Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), via <<http://www.aaofii.com/en/about-aaofii/about-aaofii.html>> accessed: 15 May 2014

<sup>218</sup> Islamic Financial Services Board via <<http://www.ifsfb.org/>> accessed: 15 May 2014

<sup>219</sup> Supra, Note. 676, p.16

## 2.4 IN SEARCH OF 'LEVEL-PLAYING FIELD'

There is no specific definition of 'level-playing field' and defining such a notion is rather a philosophical problem. However, there have been various illustrations which can provide a useful indication of what level-playing field ought to mean. Level-playing field has been argued as a metaphor taken from team sports.<sup>220</sup> For instance, the 'levelling' is to make sure that all sports team have equally the same number of players, all equally free of drugs intake and all teams compete on the same ground. However, the application such metaphor level-playing field that was once used in sports has been widely accepted in other domains.

Level-playing field has been interpreted differently by various fields including education, employment, business, finance, economy, taxation, and so forth. For instance, in air transport, the level-playing field is defined as;

“an environment in which all competitors, for instance, airlines, in a given market...must follow the same rules and are given an equal ability to compete.”<sup>221</sup>

In the area of taxation, a body which promote policies to improve the economic and social well-being of people namely the Organisation of Economic Co-operation and Development (OECD) defined the level-playing field as;

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<sup>220</sup> Ethan B. Kapstein, 'Economic Justice in an Unfair World: Towards a Level-Playing Field', (2007), p.128. (*review essay of Risse, M. (2006) see Risse, M. in bibliography*)

<sup>221</sup> De Leon, 'Fair Competition On A Level Playing Field In A Globalising Air Transport Environment', Airneth Paper, (2012) via <<http://www.airneth.nl/news/details/article/test-1/>> accessed: January 2013>

“implementation of high standards of transparency and exchange of information, for both civil and criminal taxation matters, within an acceptable timeline with the aim of achieving equity and fair competition.”<sup>222</sup>

From the judicial perspective, what is considered to be a level-playing field in a trial is when;

“neither party enjoying any litigation advantage over the other.”<sup>223</sup>

The illustrations by various fields above show that there are common elements of what can be regarded as representing the expression of level-playing field. Based on the illustrations above, the level-playing field denote the rights of parties to receive an equal treatment before the law. In other words, neither party should receive more treatment than the other in order to have fair competition and a fair outcome. The illustrations above can be regarded as the reflection of level-playing field. However, the question arises as to whether there are certain elements that can be made as a benchmark to regard the level-playing field regulation for Islamic banks? The next section discusses the possible elements of level-playing field regulation for Islamic banks.

Thus far, there has been little in-depth research on level-playing field and determining the common element to it. Evidence suggests that there is an absence of a clear definition of what is a level-playing field. An interpretation of level-playing field has been made in differing forms according to the subject area. Therefore, it can be

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<sup>222</sup> OECD Paper, ‘Tax Co-operation: Towards A Level-playing field’, (2007), p.6

<sup>223</sup> *The Ulster Bank v. Taggarts* [2013] NIQB 54

inferred that discussing the concept of level-playing field and interpreting level-playing field is rather open-ended.

Recent research by Morrison and White provides some discussion on the notion of level-playing field within the context of international financial regulation. In defining the notion of level-playing field, Morrison and White suggested that the notion refers to;

“an *international agreement* requiring that banks in different countries be subject to the *same capital requirements*, and also that they *charge the same* deposit rates, so that bank profits are independent of charter location.”<sup>224</sup> (emphasis added)

In this aspect, Morrison and White regard ‘international agreement’ and ‘same’ charges as keys to the notion of level-playing field. While the idea of providing the same capital requirements and charging the same deposit rates are one aspect to show fairness in international financial regulation, arguably, such an idea is somewhat too narrow to indicate what is considered as the level-playing field. Although such requirement is considered as one of the significant aspects of banking regulations, the scope of banking and financial regulation is not only confined to capital requirements and deposit rates. Other areas such as authorisation, liquidity requirements, stress testing, credit ratings, financial and disclosure requirements and so forth are also applicable to banking and financial institutions.

Level-playing field were thought to be successful in the situation where the ‘lowest common denominator’ of regulation is established. Morrison and White contend that:

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<sup>224</sup> Alan Morrison and Lucy White, ‘Level-Playing Fields in International Financial Regulation’, (2009), p.1100

“In order for a level-playing field to succeed, regulators must coordinate in adopting the *lowest common denominator regulations* that would be appropriate for the weakest regulator in a closed economy...and hence it penalises countries with better regulators.”<sup>225</sup> (emphasis added)

Questions therefore arise as to how regulation is considered to be in the lowest common denominator? And, if the level-playing field in international financial regulation is said to be the vision of the international regulators, should there be a different set of regulation for the weaker economy? And how does one determine that the regulator is the strongest or the weakest? Be that as it may, their research is nevertheless focusing on the level-playing field for multinational banks globally, the applicability of level-playing field in different economies and discusses what constitutes a level-playing field in international financial regulation. On the other hand, the focus of this chapter is to determine the potential basic elements of level-playing field regulation for Islamic banks.

Another suggestion on defining level-playing field was made by another author, Subedi, where he talks about the level-playing field treatment by the World Trade Organisation. In his paper, Subedi suggests that level-playing field represents the situation where “all competitors are given an equal opportunity to succeed...”<sup>226</sup> It was further suggested by Subedi that to ensure the playing field is truly level, “all players

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<sup>225</sup> Ibid.

<sup>226</sup> Surya P. Subedi, ‘The Notion of Free Trade and the First Ten Years of the World Trade Organization: How Level is the “Level-Playing Field?”’, (2006), p. 295

should equally be well-equipped with the appropriate sports tools, kit and accessories for each to stand fair chance of winning the game.”<sup>227</sup> Subedi further argues that:

“The creation of a level-playing field would not necessarily result in fairness unless the players have equal opportunities to prepare themselves for competition on this particular playing field. It is said that equality is possible among equals. Hence, there is a need for special and preferential or differential treatment in favour of the developing countries in the interim. Only when some parity has been achieved among nations would it be possible to speak of a level-playing field. Accordingly, a perfect level-playing field is a distant objective; the immediate goal should be to providing some leeway for those states currently ill-equipped to compete on an equal footing.”<sup>228</sup>

It is agreeable that his general interpretation of level-playing field is about fairness. Indeed, the differences of the subjects require some special and preferential or differential treatment in order to reach some parity. Similarly, the position of Islamic banks in the existing financial system is somewhat new as opposed to the conventional banking sector. Islamic banks have their unique concepts that lead them to face some risk in a different dimension than their conventional counterpart. Therefore, his argument that equality is possible among equals could not be applied in the case of Islamic banks for the fact that they are not equal to the conventional banks. Islamic banks may be similar to the conventional banks in certain aspects, but they are not the same in totality. In particular, the inherent nature of Islamic banks is distinctive from the conventional banks. As has been argued by Subedi that a perfect level-playing field is a distant objective, the differences that arise within Islamic banks

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<sup>227</sup> Ibid.

<sup>228</sup> Ibid., p.293

alone raise the question of the usefulness of the concept of level-playing field regulations.

The arguments to level-playing field as a concept is that the playing-field is hardly level, therefore, the focus of level-playing field should be concerned with “balancing the interests of various groups of states as well as the respective environments...”<sup>229</sup> Thus far, there has been an absence of a standard mechanism to determine what level-playing field is – as what is level, equal, fair and just in itself carries a subjective interpretation. Therefore, finding the balance will be a challenge since the basic concept of level, equal, fair and just is disputable. For example, what is considered level or not level to A may not be considered level to B and to C. It has been suggested that while fairness is often associated with the image of level-playing field, 'levelling' suggests a requirement of the equalisation of certain conditions.<sup>230</sup> An example can be observed in the trading environment, where A and B differ in their productive trading abilities due to their differences.<sup>231</sup> Similarly, in the context of banking and financial services, differences exist. The concept and approach that Islamic banks offer, in theory, differ due to the values it carries in comparison with the conventional banks (setting aside the economic substance of the transaction). Therefore, nothing can really be equated between the two sectors. This has therefore challenged the concept of level-playing field.

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<sup>229</sup> Ibid., p.296

<sup>230</sup> Ethan B. Kapstein, 'Economic Justice in an Unfair World: Towards a Level-Playing Field', (2007), p.129

<sup>231</sup> Ibid.



One may also question why there is the need to even think about levelling the playing field.<sup>232</sup> Indeed, the reality has shown that there are different interests of groups in different sets of environments. This raises the notion of diversity, which takes place in almost all aspects of our life which leads to the challenge of balancing the interests of various groups in their respective environments. It is, therefore, not an easy task to find such balance.

Similarly, level-playing field can also be referred to as the idea of balancing the diversity that exists in a particular setting or circumstances. As mentioned in the first chapter, the fact that the financial system is complex in nature raises the question of the utility of having the notion of a level-playing field.

## **2.5 INTERPRETING LEVEL-PLAYING FIELD**

While there is the challenge of interpreting and building a level-playing field, level-playing field nevertheless remains a relevant issue to be discussed. This is because, as highlighted earlier, 'level-playing field' has been a popular notion among the government and authorities in various fields. In regards to this research, treating Islamic banks on a level-playing field with the conventional banks has frequently been announced by governments and regulators in the country where there is the existence of Islamic banks - whether Islamic banks' are governed within the single or dual – regulatory framework. Below are some examples of the statements made by authorities in various jurisdictions:

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<sup>232</sup> Ibid.

## **United Kingdom**

“We will not champion Islamic finance over conventional finance, but will instead strive to create a *level-playing field* between Islamic and conventional finance.”<sup>233</sup> (Ian Pearson, Economic Secretary to the UK HM Treasury) (emphasis added)

“The Government wishes to see, where relevant and practical, a *level-playing field* established for Islamic finance.”<sup>234</sup> (UK HM Treasury) (emphasis added)

“The Government will continue to engage regularly on taxation issues relating to Islamic financial products to ensure a level playing field with conventional equivalents.”<sup>235</sup> (UK HM Treasury) (emphasis added)

“A minimum level of international consistency in measures to address the Systemically Important Financial Institutions (SIFI) problem will be essential if a *level-playing field* is to be maintained... and... the UK authorities will continue to participate actively in ongoing international work on macro-prudential policy with the aim of achieving international consistency and a *level-playing field*.”<sup>236</sup> (HM Treasury) (emphasis added)

## **Malaysia**

“In a dual financial environment, the prudential regulatory design needs to take into account the unique characteristics peculiar to Islamic banking and finance as well as provide a *level-playing field* in relation to conventional banking and finance so as to

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<sup>233</sup> HM Treasury, ‘The Development of Islamic Finance in the UK: The Government’s Perspective’, (2008), p.3

<sup>234</sup> Ibid, p.13

<sup>235</sup> Ibid., p.17

<sup>236</sup> HM Treasury, ‘A New Approach to Financial Regulation: Building A Stronger System’, (2011), p.17

ensure that Islamic financial institutions and transactions are not at a comparative disadvantage.”<sup>237</sup> (Zeti Akhtar Aziz, Governor of Central Bank of Malaysia) (emphasis added)

“It is within this context of diversity of systems and players that the regulatory approach adopted needs to ensure harmonisation and a *level-playing field* for a competitive and robust financial system.”<sup>238</sup> (Zeti Akhtar Aziz, Governor of Central Bank of Malaysia) (emphasis added)

### **Australia**

“It is about creating a *level-playing field* for the provision of Islamic financial products into the Australian market.”<sup>239</sup> (Nick Sherry, Assistant Treasurer of Australia) (emphasis added)

### **Hong Kong**

“The Hong Kong Monetary Authority’s supervisory policy for holdings of Sukuk is based on the principles of a *level-playing field* and economic substance.”<sup>240</sup> (Hong Kong Monetary Authority) (emphasis added)

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<sup>237</sup> BNM, ‘New Opportunities, New Market and New Frontier in Islamic Banking & Finance’, (Governor’s speech), (August 2004) via <<http://www.bnm.gov.my/>> accessed: 5 July 2015

<sup>238</sup> BNM, ‘Approaches to Regulation of Islamic Financial Services Industry’, (Governor’s speech), (May 2014) via <<http://www.bnm.gov.my/>> accessed: 5 July 2015

<sup>239</sup> Australia Launches Sharia Compliant Project Initiative via <<http://www.globalislamicfinancemagazine.com/>> accessed 5 July 2015

<sup>240</sup> Islamic Finance in Hong Kong: Supervisory Issues, (2008) via <[http://www.hkma.gov.hk/media/eng/publication-and-research/quarterly\\_bulletin/qb200812/fa2\\_print.pdf](http://www.hkma.gov.hk/media/eng/publication-and-research/quarterly_bulletin/qb200812/fa2_print.pdf)> accessed 5 July 2015

Thus, if the notion 'level-playing field' does not carry any weight nor importance, the regulators would not have mentioned such notion in their agenda for Islamic banks<sup>241</sup> and subsequently provide some regulatory accommodation for Islamic banks. Therefore, the question of level-playing field remains relevant and this leads to the next discussion on the approach to determine level-playing field regulation.

For the purpose of this research, an ideal approach to determine the level-playing field regulation for Islamic banks is to question:

- (iii) Whether Islamic banks are treated equally before the law; and
- (iv) Whether Islamic banks are given a fair opportunity to compete alongside the conventional banks.

The two elements above should exist together. When the law is seen to treat Islamic banks equally before the law (for instance, through a specific legal accommodation for Islamic banks) the element of fair opportunity to compete is the result of the first element. The elaboration on the difference between the two elements is described in the next sub-section. Notably, the approach above is rather flexible.

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<sup>241</sup> Michael Ainley, Ali Mashayeki, Robert Hicks, Arshadur Rahman, and Ali Ravalia, 'Islamic Finance in the UK: Regulation and Challenges', (2007), p.11, Bank Negara Malaysia, Speech: Zeti Akhtar Aziz at the IFSB Summit – Islamic Financial Services Industry and the Global Regulatory Environment – Approaches to Regulation of Islamic Financial Services Industry', (2004) via <<http://www.bnm.gov.my/>> accessed: 10 September 2014

Another approach to determine whether there is a level-playing field is by asking when level-playing field is said to be distorted. In other words, what is not a level-playing field? It can be viewed that the playing-field is not level when the answer to the above questions depict an obvious, not a mere, negative outcome - where the subject is not entitled to a fair opportunity and not treated equally before the law thus the outcome reflects the absolute biasness on the part of the regulator. For example, there is no recourse to consultation process on arising issues and there is an absence of fair treatment before the court of law. Both approaches can be used concurrently. It can be argued that a result is said to be positive when the outcome of the existing law provides sufficient space, if not full; for the Islamic financial sector to develop.

A hypothetical position is created for the conventional banks and Islamic banks as legal persons in order to position them as the subjects of the research. The legal persons are divided according to the transaction type.

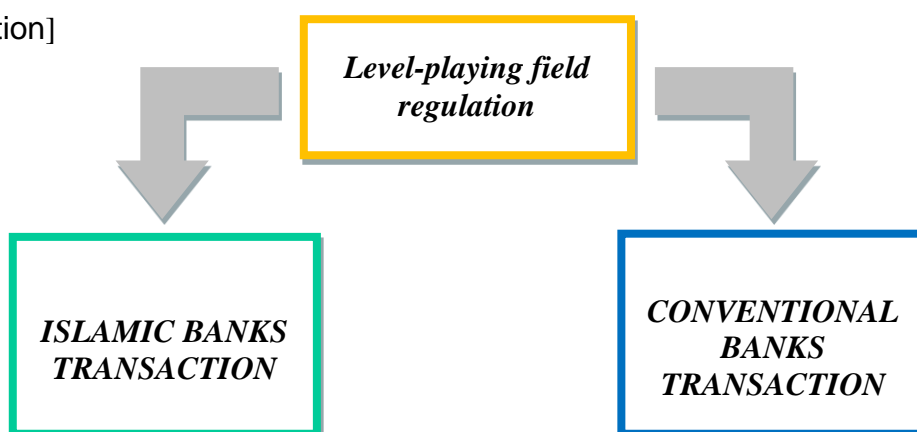


With the suggested questions above, it is to be borne in mind that legal person A and legal person B is the subject in the level-playing field regulation. The aspects included are the status between the institutions as well as the type of transaction. Both types of level-playing field can be best referred through the following diagram:-

[Status]



[Transaction]



Source: Author's own

The following subsection illustrates how the two questions are viewed.

### (i) Whether Islamic banks are treated equally before the law

The nature of law is to maintain order in society, for without law, there is no order.<sup>242</sup>

The rule of law is to impose society to do or not to do particular acts hence its role is, therefore, significant. The value of law itself is realised when the subjects are obliged to obey the rules set to them, because they are law.<sup>243</sup> However, the meaning of law and order is relative, and even sometimes the desirability of having them can be

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<sup>242</sup> Wade Mansell, Belinda Meteyard and Alan Thomson, *A Critical Introduction to Law*, (1995), p.6

<sup>243</sup> Ibid.

questionable by different societies.<sup>244</sup> The differences in perspectives are commonly due to the underlying beliefs - be it social, economic, religious, or political.<sup>245</sup> Thus, law does not necessarily solve each concrete problem, because each problem involves various aspects and perspectives.

The nature of law is that it is often associated with justice in the sense of treating different individuals impartially<sup>246</sup> - although the desired outcome may not necessarily be achieved. It can be said that the element of equality before the law appears to be associated with the notion of fairness. For instance, in the judicial proceeding, fairness denotes the equal treatment to parties where each party has the right to the disclosure of materials in the course of legal proceedings.<sup>247</sup> While in the legal context, the notion of level, equality, and fairness imply a close association with justice. The notion of level, equality, and fairness, however, cannot be simply interpreted as a direct meaning to natural justice. This can be inferred from the description of natural justice by scholars. In defining what natural justice is; Lord Denning perceives justice as;

“the solution that the majority of right-minded people would consider fair.”<sup>248</sup>

Social contract theorist, John Rawls suggests that natural justice is;

“...the result of a fair agreement or bargain” to the extent that “the spiritual aims or the aims of those of different religions may be opposed.”<sup>249</sup>

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<sup>244</sup> Ibid.

<sup>245</sup> Alan Watson, *The Evolution of Law*, (1985), p.118

<sup>246</sup> Supra. Note. 242

<sup>247</sup> Lord Mustill in *Re D (Minors)* [1996] AC 593

<sup>248</sup> Charles Stephens, *The Jurisprudence of Lord Denning*, (2009), p.2

<sup>249</sup> John Rawls, *A Theory of Justice*, (1972), p.14

In line with Rawls' argument, Amartya Sen argues that;

“the public conception of justice should be, so far as possible, independent of controversial philosophical and religious doctrines.”<sup>250</sup>

It is to be noted that the interpretation of social contracts by Rawls and Sen is related to the concept of justice and fairness to individuals, while the existing discussion of such concept is related to institutions. Therefore, one may argue that Rawls' and Sen's ideas are not related within the context of fairness at the institutional level. While it is agreeable that their arguments are not directly related to the discussion at hand, nonetheless, it can be argued that their idea of justice and fairness (on individuals) with the existing discussion could be extended to the concept of justice and fairness among institutions. This is for the fact that institutions (regulatory bodies) are operated by individuals; who essentially makes the regulatory policy based on what they perceived as justice and fairness towards the banking sector. Essentially, the banking institutions are also led by individuals. Notably, the performance of Islamic banks is, to a certain extent, affected by the regulations which are based on the idea of fairness by the regulators. Therefore, the perceived justice and fairness by individuals within the regulatory in the institutions against other institutions (banking sector) can be reflected from the idea of natural justice and fairness as argued by Rawls and Sen. Despite this, it is to be noted that their arguments highlighted earlier are limited only for the purpose of understanding the basic idea of natural justice and fairness. Therefore, this research does not intend to discuss their ideas philosophically at a deeper level as it requires a separate discussion and it is also not within the context of this research.

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<sup>250</sup> Amartya K. Sen, *Inequality Revisited*, (1992), p.76



It can be inferred from the quotations above that although the literal meaning of justice implies the notion of fairness and equality, it can also be argued that the concept of justice and fairness also represent the neutral treatment to subjects by a group of rational individuals with the aim to achieve a fair outcome – to the extent that the aim of religion and philosophical doctrines may be neglected.

It can also be argued that from the legal context, there is a thin line between the concepts of fairness, level, equality, with justice. The concept of neutrality in law that neglects the aim of religion and philosophical doctrine can be associated to the case of Islamic banks. For instance, when a law is regarded as neutral, the law may not necessarily be expected to serve the ideals of Islamic finance which is theoretically based on Sharia (religion doctrine). As will be shown in the UK chapter, the regulatory accommodation for Islamic banks in the UK is not based on serving the Sharia principles. Some of the regulatory accommodation is given because there is no legal accommodation for such types of transactions in the conventional regulatory framework. For example, in the case of Sukuk. It can also be inferred in the later chapter that there is no legal accommodation for Islamic banks where the economic outcome is the same as the conventional transaction. It can also be seen that the legal accommodation for Islamic banks are basically to promote the sector but not necessarily because of the Sharia precepts. Essentially, the objectives of banking regulation are free from any religious or philosophical influence. Hence, the neutrality in the objectives of banking regulation cannot be expected to serve the Islamic financial ideals.

One of the features of law is to promote justice and fairness; the law should be able to balance the interests of various groups. Thus, a good law should have the ability to develop the utmost level-playing field environment. But the important question to be asked is whether a complete level-playing field environment can exist? Can the regulators enable such a concept?

For it is difficult to obtain a complete level-playing field, the level-playing field interpretations by various fields have nevertheless provided some positive indication that fairness and equality should prevail - although in reality, there is no absolute equality and fairness.

The question as to whether Islamic banks in the UK and Malaysia are treated equally before the law requires an examination of how Islamic banks are treated in the existing regulatory framework. Therefore, attention is directed to the regulatory accommodation for Islamic banks to function and develop in the UK alongside the conventional banks. This question will help to provide a clearer picture as to how the regulators adopt its existing regulation and apply them to Islamic banks. In other words, equality before the law represents what exactly Islamic banks are owed; and hence this research analyses the extent to which the law serves the need of Islamic banks. In other words, if there is an absence of law for Islamic banks, but the law does not affect the functions of Islamic banks nor poses any unusual risks to the banks, there cannot be inequality before the law as the subject (Islamic banks) is not owed of anything. As such, in terms of the context of equality, it has been argued that “nobody can complain that her claim is not fully satisfied if all are satisfied equally.”<sup>251</sup>

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<sup>251</sup> Supra. Note. 83, p.130

Equality before the law consists of two types of equality. In equality law, the law consists of formal equality and substantive equality. From the legal perspective, the famous sayings of Aristotle on “treating like things alike, and unlike things alike” represent the notion of formal equality.<sup>252</sup> This maxim reflects treating equally the like group together and unlike group together. It prohibits direct discrimination. For example, it is “unlawful to base a decision about a person on a prohibited classification, such as being a woman or being black.”<sup>253</sup> Equality before the law is also related to the context of status. For example, all people are regarded as equals. All people are regarded as equals when they have equal rights “in regards to access to positions and facilities.”<sup>254</sup>

Substantive equality means “treating differently different situated people differently to equalise their positions in recognition of those differences.”<sup>255</sup> Substantive equality provides the platform for justice to be applied when “it is not sufficient to treat people identically at the formal level, since certain groups experience such disadvantage that they are unable to compete in the race in the first place.”<sup>256</sup> In other words, the law attempts to avoid indirect discrimination through the concept of substantive equality.

The types of equality mentioned above mainly referred to the social contract theory and indeed it is impossible to equalise it with the current discussion, however, it can

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<sup>252</sup> Cane Conaghan, ‘*The New Oxford Companion to Law*’, (2008), p.403

<sup>253</sup> Ibid.

<sup>254</sup> Ibid.,p.402

<sup>255</sup> Ibid.

<sup>256</sup> Ibid.

be suggested that the principle of equality from the social contract theory could be a useful reference to examine the existing question at hand. Note that the issue of discrimination is not intended to be discussed for it is irrelevant in the current context.

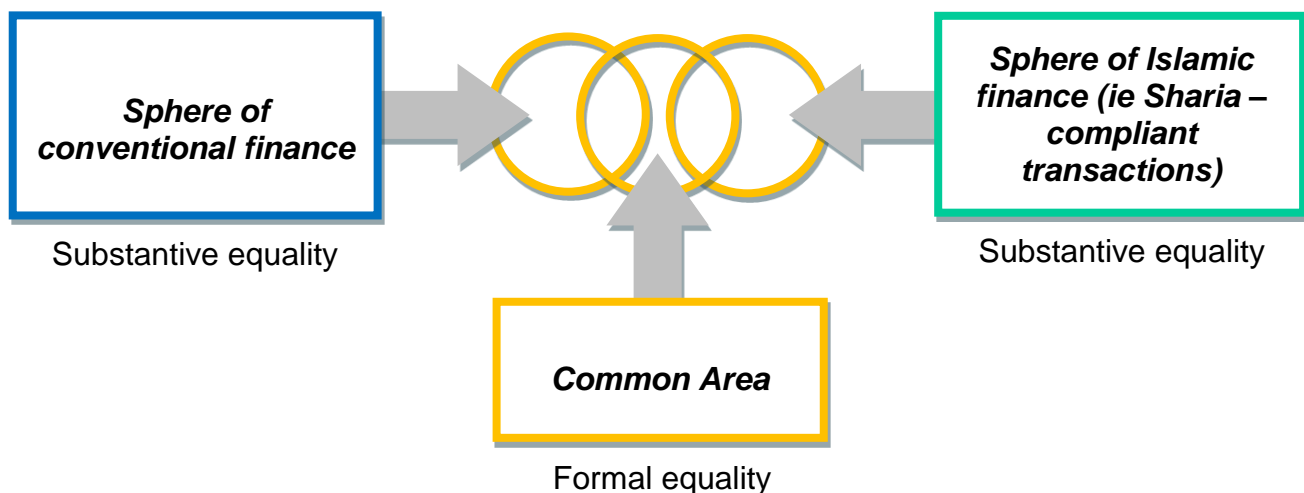
Formal equality requires the law to treat these legal persons alike. Which means the law shall remain in a general form to accommodate both banking sectors. Substantive equality requires the law to accommodate the differences of both banking sectors by giving recognition to the basic differences of both banking sectors. For example, substantive equality should recognise the Sharia-compliant aspect of Islamic finance and its transactional nature, the risks exposed, and the contractual relationships between the parties. In order to achieve the desired equality, it can be suggested that the principle of formal equality and substantive equality must co-exist. Nevertheless, question arises as to whether substantive equality must exist all the time? Arguably, while it is desirable that substantive equality exists in most instances, nevertheless the absence of substantive equality at some point should not necessarily render the existing law (formal equality) as an invalid law. This is because, the functions of law are not to ensure that there is a substantive equality in every aspect because the making of law also involves social and economic aspects of making a law.<sup>257</sup>

Apart from the above, equality before the law also denotes the kind of legal treatment that Islamic banks receive when dispute arises. This can be achieved through formal equality whereby disputes are brought before the court in a fair manner. Formal equality also allows any particular issues in the Islamic banking sector to be consulted through the consultation process in the same manner that the conventional banking

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<sup>257</sup> Supra, Note. 43, p.118

sector is entitled to. Hence, it can be argued that any Islamic banking issue which is regarded to be similar to the conventional banking should be treated equally, and issues which are dissimilar should be treated accordingly. The application of both types of equalities is regarded as equality before the law. The summary of this is illustrated in the diagram below.



Source: Author's own

**(ii) Whether Islamic banks are given a fair opportunity to compete alongside conventional banks.**

The idea behind this second question is to determine whether the existing regulatory accommodation provides enough opportunity for Islamic banks to compete fairly with the conventional banks. An ideal law should be able to accommodate a fair opportunity for the parties to compete. It is a rather difficult question to determine, as what is

considered as being 'fair opportunity' is debatable. A possible approach to answer this question is by examining the existing law; whether the law is an ideal law.

An ideal law, according to legal scholars, such as Lon Fuller, consists of;

"general rules that are clear, consistent, practicable, prospective, known, stable, and consistent."<sup>258</sup>

Friedrich A. Hayek viewed that all rule of laws must be;

"general, known, equal and certain."<sup>259</sup>

By the word general, he argues that the law be set out in advance in abstract terms not aimed at any particular individual. The application of the law is to everyone whose conduct falls within the prescribed conditions of application.<sup>260</sup> Whereas for the rule of equality, Hayek argues that the law should be applicable equally to everyone without making any arbitrary distinctions among people. Hence, when distinctions exist, "the law can only be considered legitimate when it is approved by a majority of people inside as well as outside the group targeted for differential treatment."<sup>261</sup> Law is required to be certain so that "the subject of law able to predict reliably what legal rules will be found to govern their conduct and how those rules will be interpreted and applied."<sup>262</sup> These thoughts on the natural ideal law are, however, somewhat distinct

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<sup>258</sup> Supra, Note. 115, p.661

<sup>259</sup> Frederick A. Hayek, *The Constitution of Liberty*, (1960), p.208-209

<sup>260</sup> Frederick A. Hayek quoted in Brian Z. Tamanaha, *On the Rule of Law: History, Politics, Theory*, (2004), p.66

<sup>261</sup> Ibid.

<sup>262</sup> Ibid.

from the ideal law for banking regulation. The latter can be considered to be more specific than the natural ideal law because of its specificity.

The regulation for banks, for instance in the UK, derives from the objective of financial services regulation in the Financial Services and Markets Act 2000. The objectives of banking regulation are to promote financial stability, market confidence, public awareness, the protection of consumers, and the reduction of financial crime.<sup>263</sup> It can be suggested that an ideal banking regulation is where the general rules of the ideal law is combined with the regulatory objectives of the Act. This means that, underneath the ideal law there is specific ideal law – which is the law for banking institutions. Further discussion on banking regulation can be found in the following chapters. Based on the concept of ideal law, Islamic banks should be able to compete fairly with its conventional banking counterparts. As mentioned earlier, the first and second element should exist concurrently in order to see if the level-playing field has been enabled.

The concept of level-playing field has been discussed and it has also been argued that the analysis of the concept of level-playing field regulation is relevant. The following section discusses the challenges and realities that seem to collide with the concept of level-playing field regulations for Islamic banks. The challenges and realities are based on four main circumstances: (i) legal pluralism (ii) legal change (iii) level-playing field and the risks to Islamic banks (iv) level-playing field and Islamic banks' stability. In turn, these circumstances have revealed the limits of level-playing field regulations and have questioned its relevance.

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<sup>263</sup> Sections 3-6 Financial Services and Markets Act 2000

## **2.6 LEVEL-PLAYING FIELD: CHALLENGES AND REALITIES**

- (i) Legal pluralism**
- (ii) Legal change**
- (iii) Level-playing field and the risks to Islamic banks**
- (iv) Level-playing field and Islamic banks' stability**

### **(i) Legal pluralism**

It can be argued that the concept of level-playing field regulation appears to clash with the doctrine of legal pluralism that already exists in the existing financial system environment. The concept of legal pluralism is used “to characterise the interaction between competing and conflicting official legal systems or between an official legal system and one or more of the other normative systems.”<sup>264</sup> This essentially leads to a complex and multisided interplay.<sup>265</sup>

Under the concept of legal pluralism, Tamanaha argued that there are six systems of normative ordering in social arenas.<sup>266</sup> One of them is the religious normative system. With regards to the religious normative system, Tamanaha asserts that:

“Although customary and religious sources of normative ordering are usually seen in terms distinct from and broader than official legal systems, they also can contain a

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<sup>264</sup> Brian Z. Tamanaha, ‘Understanding Legal Pluralism’, (2007), p.399

<sup>265</sup> Ibid.

<sup>266</sup> Ibid., p.397. The six systems are: (i) Official legal systems (ii) customary/cultural normative systems (iii) religious/cultural normative systems (iv) economic/capitalist normative systems (v) functional normative systems (vi) community/cultural normative systems.



subset of norms that have specifically 'legal' status, in two different senses (1) through recognition by the official legal system; or (2) on their own terms."<sup>267</sup>

Based on the above illustration, the Sharia precepts in Islamic finance are one example of the religious normative system that contained some legal status that is recognised by the official legal system (common law). The law for banking and financial services institutions in the UK and Malaysia which functions on the basis of the English common law acknowledged the religious precepts in Islamic finance and provide regulatory accommodation for Islamic banks. This has essentially justified that Sharia principles, originally derived from the Quran, have obtained some form of 'legal' status in the UK and Malaysia banking law which is based on the common law system. As such, while the law should not be expected to serve the Islamic financial ideals due to its neutral factor, the reality has seen some regulatory accommodation being put in place to suit the nature of Islamic finance.

Islamic financial transactions can also fall within another type of normative orderings within the concept of legal pluralism, that is, the economic/capitalist normative systems. This type of normative system "consists of the range of norms and institutions that constitute and relate to capitalist production and market transactions with social arenas."<sup>268</sup> In this regard, the norms of Islamic finance is seen as having been

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<sup>267</sup> Tamanaha asserts that "many official legal systems explicitly recognise and incorporate customary norms and institutions, and religious norms institutions. Many post-colonial state legal systems, for example, acknowledge and enforce customary rules and practices in connection with marriage, divorce, inheritance..." It can be argued that the practice is now extended to Islamic finance matters. Whereas the second type 'on their own terms' refers to the situation where "certain customary systems have bodies of what the members consider 'customary law', entirely apart from whether the norms and institutions so identified are recognised as such by the official legal order. He provides an example of 'natural law principles' in the Catholic tradition. Ibid., p.398

<sup>268</sup> Ibid.

incorporated in the official legal system (common law) and the latter recognised Islamic finance as having legal status. For instance, the implementation of Sharia principles in the Islamic finance commercial contract are recognised and incorporated in the economic system. The existing two normative orderings systems (religious normative and economic/capitalist) have therefore resulted to a clash. This type of clash has been argued to be one of the common types of fundamental orientation clashes under legal pluralism.<sup>269</sup> In regards to the banking practices, the prohibition of usury (Riba) in Islamic finance (religious norms) can be inconsistent with the existing economic norms relating to contract, property and credit. The prohibition of Riba in Islamic finance which is inconsistent with existing modern banking practices has been reconciled through the restructuring of Islamic financial transactions and that has been accepted by the UK regulators. For example, the next chapter illustrates that there is specific regulatory accommodation for Sharia-compliant liquid assets due to the prohibition of interest in Islamic finance. It can therefore be inferred that there is already the incorporation of the concept of legal pluralism in the existing financial system that is complex and diverse.

However, the concept of legal pluralism has its limitation whereby the incorporation of the conflicting normative systems can result in socio-political tension. Legal pluralism is also said to be an important aspect that can contribute to the fate of state legal systems. As argued by Tamanaha:

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<sup>269</sup>Ibid.,p.407-409. The other three clashes are (i) Liberal (Individual) versus Non-Liberal (Non-Individualist) Cultural Norms (ii) Systems that recognise or draw a sharp separation between public and private realms versus those that do not (iii) Rule-based systems with winners and losers versus consensual systems oriented towards satisfactory resolution.

“People and groups in social arenas with coexisting, conflicting normative systems will, in the pursuit of their objectives, play these competing systems against one another. Sometimes these clashes can be reconciled. Sometimes they can be ignored. But very often they will remain in conflict, with serious social and political ramifications....As in the medieval period, today they are coexisting, discrete legal orders that can overlap and clash, ranging from various official legal orders to the *lex mercatoria* and the Sharia...When placed in historical context, it is apparent that the texture of legal pluralism is intimately to the activities and fate of state legal systems.”<sup>270</sup>

Based on the illustrations above, it can be inferred that the incorporation of Sharia regulation in the conventional regulatory framework is one aspect that arises from the doctrine of legal pluralism. Other aspects include the risks posed to Islamic banks and the need to develop the Islamic financial sector. Such incorporation that already exists can be said to have contributed to the fate of the existing regulatory framework for the banking and financial institutions at the macro level. For instance, the incorporation of Sharia in the conventional regulatory framework for banking and financial institutions have seen several legislative amendments that somewhat provide an altogether new dimension for the banking sector in the UK. Whereas, for Malaysia, the incorporation of Sharia for Islamic banks through dual regulatory framework has similarly altered the dimension for the regulations governing banking and financial services institutions.

However, the two normative orderings (religious and economic/capitalist system) can co-exist only to a certain extent. If Islamic finance is given special attention by the regulators over any other form of financial services, some political and social

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<sup>270</sup> Ibid., p.409

ramifications can be expected in a secular society such as the UK. For instance, the suggestion made in the year 2008 by the Archbishop of Canterbury, Dr. Rowan Williams, on the need to incorporate some Sharia aspects (in particular, he was referring to marital disputes) in Britain has stirred large criticisms by the British public, politicians and government officials.<sup>271</sup> His suggestion on the incorporation of Sharia law in Britain reflects that inclination towards Sharia matters in Britain could easily result to socio-political tension.

Note that in Malaysia, there is no evidence to suggest that the inclination of the government towards Islamic banks would result to socio-political tension. In fact, recent demographic survey has shown that in Malaysia, Islamic banks are well supported by the non-Muslims population.<sup>272</sup> In the survey, 41.8% of Christians, 27% of Buddhists and 33.1% of Hindus use Islamic banking services. This demonstrates that there is public support for Islamic financial sector in Malaysia because large segments of the non-Muslim population choose Islamic banks despite the availability of conventional banks. As such, evidence suggests that there is little socio-political tension for the government's support for Islamic banks.

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<sup>271</sup> Steve Doughty and Michael Seamark, 'Sharia Law Row: Archbishop is in Shock as He Faces Demands to Quit and Criticism from Lord Carey', *News*, (9 February 2008) via <<http://www.dailymail.co.uk/news/>> accessed: 12 July 2015 and 'Sharia Law in UK is 'unavoidable'', *News*, (7 February 2008) via <<http://news.bbc.co.uk/1/hi/uk/7232661.stm>> accessed: 21 August 2015 See, 'Archbishop's Lecture - Civil and Religious Law in England: a Religious Perspective', (7 February 2008) via <<http://rowanwilliams.archbishopofcanterbury.org/>> accessed: 21 August 2015

<sup>272</sup> Malaysia Islamic Finance Report: Mainstreaming Islamic Finance with Global Financial System', (2015), p.120

The objectives of banking regulation that are generic (neutral law) do not target any particular form of financial services (such as Islamic banks or co-operative banks) (Note that the discussion on the purpose of banking regulation is contained in Chapter 5 of this thesis). Notably, the general objectives of banking regulation are mainly for depositor protection and to avoid banking failures which arise from externalities.<sup>273</sup>

Therefore, it can be suggested that the limits of legal pluralism (particularly in the UK) adds to the challenge of incorporating the concept of level-playing field regulation for banking and financial services institutions (whereby banking regulations should be free from any religious beliefs).

## **(ii) Legal change**

The law is said to develop by the influence of other factors such as culture and social, economic, and political factors.<sup>274</sup> Additionally, it can be said that the concept of legal pluralism also contributes to legal change. As a consequence, legal change makes the law that was enforced and relevant in the past unenforceable and irrelevant in today's world. Similarly, banking and financial services regulation has undergone legal change due to the constant changes in the financial system. The law continues to develop when there is a development in the banking and financial services sector. That makes the law progressive. Thus law is reformed to minimise any potential risks that could impinge the health of the financial system. Some examples are the legal amendment of the Financial Services and Markets Act 2000 and the development of

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<sup>273</sup> Ethan B. Kapstein, *Governing The Global Economy: International Finance and The State*, (1994), p.18

<sup>274</sup> Alan Watson, *Legal Transplants: An Approach to Comparative Law*, (1993), p.11

Basel Accords. As such, the concept of level-playing field regulation can be said to have limitations because law will continue to evolve to suit its current nature. Just like the legal accommodation for Islamic banks. This, therefore, creates the challenge for level-playing regulation for Islamic banks to be relevant within the established conventional concept of banking regulation.

As mentioned in the first chapter, the fact that the financial system is complex and diverse raises the question of the usefulness of the concept of level-playing field regulation and to what extent the regulators can enable such a concept. This is because, innovation of the financial products that have always been encouraged by the regulators could, in a way, expose financial institutions to risks that differ in its dimension and degree. For example, some risks exposed to Islamic banks can be more serious than the conventional banks. As a result, the following chapters will show that the level-playing field regulation cannot be fully enabled.

### **(iii) Level-playing field and the risks to Islamic banks**

The idea of having level-playing field treatment indicated by governments and regulators is seen as showing their support to promote fairness towards all the financial institutions operating in their jurisdiction (although the extent of the government's support varies with respect of providing regulation for Islamic banks). While the concept of level-playing field represents the idea of fair treatment for Islamic banks, the question remains as to what extent level-playing field regulation can be connected with Islamic banks?

Creating a level-playing field for Islamic banks represents the government's acknowledgment of the unique nature of Islamic finance and to a certain extent, understanding some of the risks attached to Islamic banks.<sup>275</sup> Additionally, it can be suggested that such treatment could promote fair competition for Islamic banks. Various works have also supported the treatment of a level-playing field for Islamic banks as a means toward helping the sector to continue to develop in the financial world.<sup>276</sup> This is done through providing legal accommodation for Islamic banks in the area that poses risks specific to Islamic banks. (The following chapters discuss the extent of regulatory accommodation for Islamic banks and it can be inferred that not all risks exposed to Islamic banks are compensated by providing specific legal accommodation – hence the usefulness of the concept level-playing field remain questionable).

Due to the principles of Sharia in Islamic finance, it has been argued that some of the risk profiles attached to Islamic banks are distinct from the risk profiles experienced by conventional banks.<sup>277</sup> This means that although the risks exposed to Islamic banks

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<sup>275</sup> Global Islamic Finance Report 2014, and Rusni Hassan, Nurdianawati Irwani Abdullah, Aznan Hassan, Aznan Ibrahim, Mohd Fuad Md. Sawari, Akhtarzaite Abd. Aziz, Agus Triyanta, *A Comparative Analysis of Sharia Governance in Islamic Banking Institutions Across Jurisdictions* (2013)

<sup>276</sup> See, Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking*, (2010), Dahlia El-Hawary, Wafik Grais and Zamir Iqbal, 'Diversity in the Regulation of Islamic Financial Institutions', (2007), Alejandro López Mejia, Suliman Aljabrin, Rachid Awad, Mohamed Norat and Inwon Song, 'Regulation and Supervision of Islamic Banks', (2014)

<sup>277</sup> Hennie Van Greuning and Zamir Iqbal, *Risk Analysis for Islamic Banks*, (2008), Alejandro López Mejia, Suliman Aljabrin, Rachid Awad, Mohamed Norat and Inwon Song, 'Regulation and Supervision of Islamic Banks', (2014), Inwon Song and Carel Oosthuizen, 'Islamic Banking Regulation and Supervision: Survey Results and Challenges', (2014), Martin Čihák and Heiko Hesse, 'Islamic Banks and Financial Stability: An Empirical Analysis', (2008), Dahlia El-Hawary, Wafik Grais and Zamir Iqbal,

are similar with conventional banks, the way Islamic banks are exposed to such risks can sometimes be nevertheless more serious or less serious than its conventional counterpart. In other words, Islamic banks are exposed to the same type of risks similar to the risks faced by conventional banks but by differing degrees and dimensions. Therefore, enabling a complete level-playing field regulation is a challenging concept.

Note that although the focus of this thesis is on the issue of level-playing field for retail Islamic banks, nevertheless, it is important to highlight the risks exposed to Islamic banks in totality as banks' risks affect all types of Islamic banks – whether wholesale or retail. The examples below highlight several types of risks that can affect Islamic banks in a different context as opposed to the conventional banks. Risks include, but are not limited to, general risk management, credit risk, market risk, operational risk, profit rate risk, equity investment risk, Sharia non-compliance risk, liquidity risk and counter-party risk.

#### **(a) General Risk Management**

With regards to the general aspect of risk management, Islamic banks generally require the same approach as the conventional banks. Similar to the conventional banks, Islamic banks need appropriate sound risk management that can ensure its systems, procedures and governance are well-structured. However, at the specific level, several authors have argued that the risk profile of a typical Islamic bank may

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'Diversity in the Regulation of Islamic Financial Institutions', (2007), V. Sundarajan and Luca Errico, 'Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead', (2002).



differ from a conventional bank.<sup>278</sup> Due to the Sharia-compliance principle, factors such as the construction and legal form of the transaction(s), the assets and liabilities which arise from the transaction(s), the risks undertaken, and the party absorbing the risk need to be taken into account for Islamic banks' risk management.<sup>279</sup> These factors arise from the different approach of Islamic financial contracts as opposed to the conventional financial contracts. While Basel requirements provide the risk management guidelines for banks globally, such requirements may not be fully suitable for the inherent nature of Islamic banks. Therefore, guidelines issued by the Islamic Financial Services Board (an international standard setting body for Islamic financial institutions) which complements Basel standards are highly recommended to reduce the risks specifically exposed to Islamic banks.<sup>280</sup> This approach can produce a better regulatory framework for Islamic banks, although not necessarily ensure a complete level-playing field.

## **(b) Credit Risk**

While the conventional banks are also exposed to credit risk, the overall credit risk faced by Islamic banks may differ and could be higher from the risk profile of conventional banks.<sup>281</sup> In some of the Islamic financial contracts, for instance, in Murabaha contracts (cost-plus financing), "Islamic banks are exposed to credit risks

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<sup>278</sup> Ibid.

<sup>279</sup> Inwon Song and Carel Oosthuizen, 'Islamic Banking Regulation and Supervision: Survey Results and Challenges', (2014), p.24

<sup>280</sup> IFSB Guiding Principles on Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services IFSB-1 (2005) via <<http://www.ifsb.org/published.php>> accessed: 17 June 2015

<sup>281</sup> Alejandro López Mejía, Suliman Aljabrin, Rachid Awad, Mohamed Norat and Inwon Song, 'Regulation and Supervision of Islamic Banks', (2014), p.10

when the bank delivers the goods to the client but does not receive prompt payment from the client.”<sup>282</sup> In this case, Islamic banks are “prohibited from charging any accrued interest or imposing any penalty (except if there is a deliberate delay).”<sup>283</sup> As such, during such delay, the “bank’s capital is stuck in a non-productive activity and the bank cannot earn any income.”<sup>284</sup> However, in order to solve this issue, it has been said that Islamic banks mitigate such risk through better collateralisation.<sup>285</sup> In Mudaraba contracts (participation or trust financing), when an Islamic bank enters the contract as ‘principal’ with an external ‘agent’ (borrower), the bank is exposed to enhanced credit risk especially when the bank is unable to monitor the business operations accurately, and losses are claimed.<sup>286</sup>

### **(c) Market Risk**

Market risk is associated with changes in the market value of held assets. A bank “may experience loss due to unfavourable movements in market price, such as the in the case of yields or benchmark rates (rate of return risk), foreign exchange rates, as well as equity and commodity prices (price risk).”<sup>287</sup> Notably, the market risk exposed to Islamic banks may differ from the market risk profile of the conventional banks. Islamic banks are not allowed to be involved in speculative transactions due to Sharia prohibitions; hence market risk can affect Islamic banks differently than towards the conventional banks. Islamic banks can be exposed to market risk arising from the presence of multiple counterparties that are involved in Islamic banking transactions

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<sup>282</sup> Supra, Note. 142

<sup>283</sup> Supra. Note. 144, p.10

<sup>284</sup> Ibid.

<sup>285</sup> Hennie Van Greuning and Zamir Iqbal, *Risk Analysis for Islamic Banks*, (2008), p.127

<sup>286</sup> Supra. Note. 142, p.24

<sup>287</sup> Ibid., p.26

such as commodity Murabaha (cost-plus financing) transactions.<sup>288</sup> Market risk also arises from commodity price risk and foreign exchange risk. Additionally, the fact that Islamic banks often invest in various types of Sukuk exposes Islamic banks to market risk that arise from the volatility of assets they traded.<sup>289</sup>

#### **(d) Operational Risk**

Operational risk is “the risk of failure of the internal processes related to people and systems”.<sup>290</sup> It is the type of risk which may expose Islamic banks to a higher extent than the conventional banks due to the complexity of their contractual features and general legal environment. Several aspects of operational risk that affects Islamic banks includes (i) cancellation risk in the Murabaha (cost-plus financing) and Istisna (manufacturing) contracts) (ii) failure of the internal control system to detect and manage potential problems in the operational processes (iii) the need to maintain and manage commodity inventories in illiquid markets and (iv) failure to adhere to Sharia requirements.<sup>291</sup>

#### **(e) Profit rate risk**

Profit rate risk faced by Islamic banks is similar to the conventional interest rate risk. However, the degree of this type of risk may differ from the conventional counterpart. Profit rate risk is generally associated with “overall balance sheet exposures where

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<sup>288</sup> Ibid.

<sup>289</sup> Ibid., p.24

<sup>290</sup> Dahlia El-Hawary, Wafik Grais and Zamir Iqbal, ‘Diversity in the Regulation of Islamic Financial Institutions’, (2007), Appendix

<sup>291</sup> Hennie Van Greuning and Zamir Iqbal, *Risk Analysis for Islamic Banks*, (2008), p.174-175

mismatches arise between assets and balances from fund providers.”<sup>292</sup> Such risk is derived from the uncertainty in the returns earned by Islamic banks. The risk arises when “an increase in benchmark rates results in expectations of higher rates of return on investment accounts.” An increase in benchmark rates will ultimately raise the expectations of Islamic bank’s investment account holders’ expectations of higher rates of return although the actual rate can only be determined until the end of the investment period.<sup>293</sup> Islamic banks often minimise this risk, however, through a profit equalisation reserve and investment risk reserves.<sup>294</sup>

#### **(f) Equity investment risk**

Islamic banks’ participation in a partnership agreement such as profit and loss sharing investments often exposes the banks to equity investment risk. Some of the examples of equity investments of Islamic banks are holding of shares in the stock markets, private equity investment, equity participation in specific projects and syndicated

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<sup>292</sup> Inwon Song and Carel Oosthuizen, ‘Islamic Banking Regulation and Supervision: Survey Results and Challenges’,(2014), p.27

<sup>293</sup> Alejandro López Mejia, Suliman Aljabrin, Rachid Awad, Mohamed Norat and Inwon Song, ‘Regulation and Supervision of Islamic Banks’, (2014), p.9

<sup>294</sup>Profit equalisation reserves (PER) – “It is an amount set aside from the investment profits before allocation between the shareholders and the unrestricted investment account holders and the calculation of the bank’s share profits. It is used to reduce the variability of profit payouts on investment deposits to offer returns that are aligned to a market rate of return without the need for the bank to forgo any of its shares when investment returns decline.” Investment risk reserves (IRR) – “It is the amount appropriated by the institution offering Islamic financial services out of the income of investment account holders after deducting the share of the bank. It can be used to redistribute over time income which accrues to investment accounts, so as to cushion against future investment losses and maintain payouts.” Ibid.,p.10

investment.<sup>295</sup> The equity investment risk is rather unique for Islamic banks due to the fact that conventional bank do not invest in equity-based assets.<sup>296</sup> This risk can lead to “volatility in the financial institutions’ earnings due to the liquidity, credit, and market risks associated with equity holdings.”<sup>297</sup> Other associated risk in equity-based investment is credit risk and financial risk as the capital may be lost due to business losses.<sup>298</sup>

#### **(g) Sharia non-compliance risk**

As the essential unique selling-point of Islamic banking is that their activities are based on Sharia principles, the non-compliance to Sharia principles will impact Islamic banks in various aspects.<sup>299</sup> For instance, reputational risk, legal risk, transparency risk, risk of Sharia governance failure, failure to treat consumers fairly and failure to provide consumer protection. This type of risk is viewed differently by different jurisdictions. In secular countries, it can be argued that the regulators will view that such risk will affect the consumers’ protection and failure to treat consumers fairly. Whereas in Muslim jurisdictions, the regulators are seen to give more acknowledgement to this type of risk and often detailed regulations is set out to ensure that Islamic banks comply with Sharia requirements. This type of risk, however, does not exist for conventional banks. This raises the need to ensure an appropriate regulation for Islamic banks.

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<sup>295</sup> Inwon Song and Carel Oosthuizen, ‘Islamic Banking Regulation and Supervision: Survey Results and Challenges’,(2014), p.27, and Hennie Van Greuning and Zamir Iqbal, *Risk Analysis for Islamic Banks*, (2008), p.160

<sup>296</sup> Hennie Van Greuning and Zamir Iqbal, *Risk Analysis for Islamic Banks*, (2008), p.160

<sup>297</sup> Ibid.

<sup>298</sup> Ibid.

<sup>299</sup> Inwon Song and Carel Oosthuizen, ‘Islamic Banking Regulation and Supervision: Survey Results and Challenges’,(2014), p.27

## **(h) Liquidity risk**

While the conventional banks also faced liquidity risk, this risk is heightened in Islamic banks due to several factors: (i) Islamic banks have often had to rely to on short-term retail funding due to the fact that the long-term funding takes greater time to reach its maturity; (ii) Islamic banks tend to operate in environments with underdeveloped Sharia-compliant interbank and money markets and government securities; (iii) there is limited ability to hedge certain risks due to prohibitions against the use of conventional derivatives; and (iv) there is limited access to lender of last resort facilities as opposed to the conventional banks.<sup>300</sup>

## **(i) Counter-party risk**

In some of the Islamic financial contracts, Islamic banks may face counter-party risk which is present in the case of deferred payment and delivery contracts when combined with Murabaha (cost-plus financing).<sup>301</sup> For instance, in Bay' Salam contract (deferred delivery) or Istisna contracts (manufacturing contracts), Islamic banks can become exposed to counter-party risk when there is a failure to supply on time or at all, or, failure to supply the quality of goods as contractually specified.<sup>302</sup> This risk can also lead to credit risk and commodity risk. Islamic banks could also be exposed to counter-party risk in Mudaraba (participation or trust financing) contracts<sup>303</sup>. For instance, as Islamic banks do not have the right to participate in the management of

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<sup>300</sup> Alejandro López Mejía, Suliman Aljabrin, Rachid Awad, Mohamed Norat and Inwon Song, 'Regulation and Supervision of Islamic Banks', (2014), p.11

<sup>301</sup> Dahlia El-Hawary, Wafik Grais and Zamir Iqbal, 'Diversity in the Regulation of Islamic Financial Institutions', (2007), p.787

<sup>302</sup> Ibid.

<sup>303</sup> Ibid.

the project, the bank may lose its principal investment and potential share if the entrepreneur suffers losses.<sup>304</sup>

#### **(j) Fiduciary risk**

Islamic banks are exposed to this type of risk due to its feature as a profit-loss sharing principle. Fiduciary risk is defined as the legal liability arising from a breach of the investment contract for mismanagement of depositors and shareholders' funds.<sup>305</sup> For example, the relationship between an Islamic bank and its account holders is a fiduciary relationship where the bank is allowed to manage the funds of the depositors based on trust.<sup>306</sup> An Islamic bank is not obliged to return the share of profits for the depositors and in the case of heavy losses arising from the mismanagement of funds from the current account holders, the latter will lose their confidence and may seek legal recourse. In the case of partnership-based investment such as Mudaraba or Musharaka, any intentional negligence in evaluating and monitoring the project can lead to fiduciary risk.<sup>307</sup>

The types of risks described above are part of the risks that Islamic banks face in a differing degrees and dimensions as compared to conventional banks. There are other types of risks faced by the conventional banks that are also applied to Islamic bank such as withdrawal risk, solvency risk, asset and liability management risk, and

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<sup>304</sup> Ibid.

<sup>305</sup> Ibid., Appendix

<sup>306</sup> Hennie Van Greuning and Zamir Iqbal, *Risk Analysis for Islamic Banks*, (2008), p.179

<sup>307</sup> Ibid.

institutional risk.<sup>308</sup> One may argue that since Islamic banks are exposed to the same risks as the conventional banks, there is no need to have a specific regulatory accommodation for Islamic banks in order to create a level-playing field. However, the counter-argument to this is that since Islamic banks are exposed to such risks in a different dimension, the degree of risks exposed to Islamic banks may be higher than the same risks exposed to the conventional banks. Therefore, to a certain extent, an appropriate regulatory accommodation that caters to the inherent risks exposed to Islamic banks is still required. However, this does not necessarily mean that a complete level-playing field can be achieved. In this regard, the regulatory framework set out by the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) is helpful to minimise the risks attached to Islamic banks. The different risks exposures remain a challenge to the level-playing field regulation. Further discussion on the IFSB and AAOIFI is highlighted in Chapter 5 of this thesis.

#### **(iv) Level-playing field and Islamic banks' stability**

It has been argued that appropriate banking regulation can help to promote the stability of the banking system.<sup>309</sup> Banking system stability has been defined as a “steady state in which the financial system efficiently performs its key economic functions, such as allocating resources and spreading risk as well as settling payments”.<sup>310</sup> In other words, a sound banking system is where banking institutions meet the solvency

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<sup>308</sup> Further illustration on these risks is provided in the Appendix section. See, El-Hawary et.al., 'Diversity in the Regulation', (2007), Appendix.

<sup>309</sup> Supra, Note. 76

<sup>310</sup> Nadya Jahn and Thomas Kick, 'Determinants of Banking Stability' via <<http://www.bis.org/bcbs/events/bhbibe/jahn.pdf>> accessed: 25 June 2015



requirements to perform the functions above. On the other hand, banking system instability can arise “either through idiosyncratic components related to poor banking practices adversely affecting an individual bank’s solvency, from systematic components initiated by aggregate shocks entailing financial strains for the banking system or a combination of both.”<sup>311</sup> Therefore, it has been argued that the “proper estimation of distress dependence amongst the banks in a system is of key importance for the surveillance of stability of the banking system.”<sup>312</sup> In this regard, the banking and financial regulators should provide appropriate regulation and recognise the importance assessing the risks exposed to the banking system; as well as aiming to provide regulation that can minimise risks affecting the banking system’s stability. Stability of banks (including Islamic banks) cannot be precisely identified as the outcome varies depending on factors such as the size of the banks, the relative size of the risks, country by country and by one bank to another.<sup>313</sup> While it is often argued that appropriate banking and financial regulation can promote the banking system’s stability<sup>314</sup>, question arises as to whether the ‘level-playing field’ regulation can provide stability to Islamic banks.

Before proceeding further, it is noteworthy that various researcher have conducted studies on Islamic banking stability in comparison with the conventional banks and have discovered varied results based on different sets of criteria. Note that the findings are not particularly based on the impact of regulation but rather the performance of

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<sup>311</sup> Ibid.

<sup>312</sup> Miguel A. Segoviano and Charles Goodhart, ‘Determinants of Banking System’, (2009) via <<http://www.imf.org/external/pubs/ft/wp/2009/wp0904.pdf>> accessed: 25 June 2015

<sup>313</sup> Alejandro López Mejía, Suliman Aljabrin, Rachid Awad, Mohamed Norat and Inwon Song, ‘Regulation and Supervision of Islamic Banks’, (2014), p.22

<sup>314</sup> Supra, Note. 76

Islamic banks based on economic variables. However, the reference to the varied research outcomes can be reflective of the fact that the performance of Islamic banks is dependent on the existing regulatory framework governing Islamic banks (at the time the research was undertaken in various countries, and it can also be assumed that the targeted jurisdictions provide regulatory accommodation for Islamic banks, either in unitary or dual regulatory framework). Differences in results are also due to the different set of regulatory treatment for Islamic banks in each country where the research was conducted. Therefore, the outcomes could not be said to be the actual result of the existing regulation because as mentioned earlier, the outcome of the research findings are based on the economic variables and differences in criteria.

Thus far, there is relatively little empirical analysis on the impact of regulation for Islamic banking stability or the role of Islamic banks in financial stability. While there is such a limitation, research indicates that Islamic banks stability (within the existing regulatory framework of differing countries) under certain criteria can be stronger or weaker or similar to the conventional banks.<sup>315</sup> For instance, a comparative research that was done between Islamic banks and conventional banks conducted in 18 countries using the economic assessment of Z-scores model have shown that large Islamic banks are weaker than large conventional banks. On the other hand, small Islamic banks are stronger than small conventional banks, and small Islamic banks are stronger than large Islamic banks.<sup>316</sup> The contributing factor for such an outcome

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<sup>315</sup> Martin Čihák and Heiko Hesse, 'Islamic Banks and Financial Stability: An Empirical Analysis', (2008), p.20

<sup>316</sup> Ibid. - The authors have argued that such result should be viewed as preliminary given caveats related to cross-country data on Islamic banks. Based on the Bankscope data, Islamic banks accounted for more than 1 percent of the total assets in at least one year in the period under observation (1993-2004). Large banks assets are over US\$1 billion and smaller banks assets are smaller than US\$1 billion.

is mainly due to the credit risk management of Islamic banks. The result has shown that Islamic banks when operating on a small scale can be more relatively stable than operating on a large scale. The researchers have suggested that the explanation for such findings is due to the fact that “it is significantly more complex for Islamic banks to adjust their credit risk monitoring system as they become bigger” as profit and loss sharing activities are more difficult to be standardised than loans in the conventional banks.<sup>317</sup>

With regards to credit risk, another comparative research has found that small Islamic banks that operate in predominantly Muslim countries (over 90% of the population) have lower credit risk than the conventional banks.<sup>318</sup> This is based on the assumption that the majority Muslims populations express greater concern about their religious beliefs and hence are more risk averse than the conventional bank’s clients.<sup>319</sup> In terms of insolvency risk, the research has found that small Islamic banks are more stable than the conventional banks as they are more capitalised.<sup>320</sup> However, there is no significant difference between large Islamic banks and the conventional banks.<sup>321</sup>

Other research has also found that during the 2008-2009 global financial crises, Islamic banks were affected differently than the conventional banks. The Islamic banking model has somewhat helped limit the adverse impact on Islamic banks and

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<sup>317</sup> Ibid., p.21

<sup>318</sup> Pejman Abedifar, Philip Molyneux and Amine Tarazi, ‘Risk in Islamic Banking’, (2012), p.5. The research was conducted using a sample of 553 banks from 24 countries between the years 1999 and 2009. Economic variables were used to identify the outcome.

<sup>319</sup> Ibid.,p.37

<sup>320</sup> Ibid.

<sup>321</sup> Ibid.

has hence shielded their profitability during the early stage of the global financial crisis. However, weak risk management affected Islamic banks' profitability during the later stage of the crisis, when the crisis hit the real economy.<sup>322</sup> Additionally, another research suggests that due to higher capitalisation, better asset quality and liquidity holdings, Islamic banks performed better than the conventional banks during the global financial crisis.<sup>323</sup>

While it seems difficult to show whether the level-playing field regulation can contribute to the stability of Islamic banks, nevertheless, it can be inferred that some regulatory accommodation can contribute to Islamic banks' stability. For instance, the next chapter shows that the regulatory accommodation on Sharia-compliant liquid assets regulation could help Islamic banks in the UK to have more options to sufficiently manage their liquidity. More on this point is provided in the next chapter.

The outcome of the research findings above are mainly based on economic variables. It does not represent specifically on the impact of the regulation towards Islamic banking stability from the legal perspective. Thus far, there is an absence of empirical research on determining the impact of level-playing field regulation and the stability of Islamic banks. Indeed, it is rather difficult to determine whether level-playing field regulation can promote stability of Islamic banks. It can, however, be argued that this issue is based on two reasons. Firstly, since the notion of level-playing field is metaphorical, there is a difficulty in directly associating the notion 'level-playing field'

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<sup>322</sup> Maher Hasan and Jemma Dridi, 'The Effects of Global Crisis on Islamic Banks and Conventional Banks: A Comparative Study', (2010), p.33

<sup>323</sup> Alejandro López Mejia, Suliman Aljabrin, Rachid Awad, Mohamed Norat and Inwon Song, 'Regulation and Supervision of Islamic Banks', (2014), p. 13

regulation and banking stability (including Islamic banks). This is because the notion 'level-playing field' cannot be equated with economic variables. Also, from the legal perspective, it is difficult to associate the level-playing field regulation with stability. Secondly, as discussed earlier, there is no specific benchmark to determine the outcome of the level-playing field, or to question what is level-playing field or the level-playing field of what, thus its relation to bank's stability cannot be specifically determined. These reasons have therefore challenged the concept of level-playing field regulation.

## **2.7 CONCLUSION**

This chapter concludes that based on the rationale and the justifications for more/simple regulations for Islamic banks, it can be said that Islamic banks are better regulated in a simpler form of regulations – especially in the UK context. While it is important to address the risks exposed to Islamic banks, it is not necessary to have a separate regulatory framework to create a level-playing field. What is needed is an appropriate regulation for Islamic banks which could help the sector to develop. In other words, it is not necessary to have more regulations for Islamic banks (as the Malaysian regulatory approach for regulating Islamic banks). This is because, the arguments above have shown that there is an absence of connection between the idea of level-playing regulations with the rationales and justifications for more/simple regulations.

Furthermore, what could be regarded as a 'level-playing field' regulation remains uncertain. The earlier section has shown that there is an absence of a clear definition

for the notion of a level-playing field. Interpretations by various fields on what constitutes a level-playing field have been made to suit the context of their existing issue. The notion of a level-playing field is, therefore, an open ended term. However, the common inference of what level-playing field means relates to the idea of fairness and the parties' equal opportunity to compete fairly. In light of this, the existence of a level-playing field concept can be inferred by analysing the two suggested elements - equality before the law and the fair opportunity to compete. These elements are arguably the guideline to determine the closest connection to what is considered as the level-playing field regulation for Islamic banks. Another approach toward finding the closest connection to the level-playing field regulation is to determine whether a lack of adjustment in the existing regulatory framework ultimately results in an obvious negative outcome, and not a mere outcome. In this regard, the relevant approach is to question whether the regulatory framework impedes the development of Islamic banks and affects the stability of the financial system as a whole.

The concept of level-playing field regulation is seen to encounter several challenges. The challenge involves the vagueness in the term itself, firstly, being an open ended metaphoric term and secondly, the overlapping concept of level, fairness, equality and justice. Thirdly, that the ideal law which was suggested by Fuller and Hayek should be made equal, general, practicable, certain, and fair is arguably a mere guideline for the regulators when making regulation. This is because, not all area of laws can be made general or certain. Likewise, not all area of laws can be made specific. Through time, laws change to suit the existing situation hence leading to the legal change. As such, there is no certainty that the laws today will be relevant tomorrow. Therefore, in some aspect, laws are amended to suit the specific nature of the subject in order to avoid

greater risks. Hence, laws may not always be general or equal or certain because law is constantly evolving. If this is the case, it can be suggested that there is nothing that can be considered as an ideal law that is relevant for all time.

Additionally, this chapter has also argued that the realities that exist in the legal and financial system pose challenges to the level-playing field regulation. Apart from the issues above, other realities such as the doctrine of legal pluralism is seen to clash with the neutral objective of banking regulation hence challenging the concept of level-playing field regulations. It was also argued that there is a clash between the level-playing field regulations and the risks faced by Islamic banks whereby the latter face some risks in different degrees and dimension than conventional banks and hence require more appropriate regulation. The chapter also pointed out that the vague connection of level-playing field regulation with the stability of Islamic banks is seen to be a challenge to the usefulness of level-playing field regulations. In sum, the notion 'level-playing field' is argued to be no more than a mere expression and metaphorical to fairness. The emphasis of the notion level-playing field made by the regulators towards the legal accommodation for Islamic banks (as shown in the later chapters) questions the value of the concept of level-playing field regulations. The interpretation of level-playing field is rather debatable and subjective, while it remains a relevant concept to be examined.

When the rudimentary concept (level-playing field / fairness / equality) is not clear or certain, and accompanied with the challenges mentioned earlier, the question is raised as to whether the level-playing field regulation is conceptually useful? Especially in the existing financial system which is considered to be diverse and complex? Following

this, the so called 'level-playing field' regulation in the regulatory accommodation for Islamic banks in the UK and Malaysia is examined in the next chapter. In particular, the next chapter analyses the extent of 'level-playing field' regulation for Islamic banks within the financial system in both jurisdictions. Therefore, the approach is to examine the regulatory framework by using the two test questions above (equality before the law and fair opportunity to compete) to analyse the level-playing field regulation at the transactional level and the institutional level.



## **CHAPTER THREE: THE REGULATORY FRAMEWORK OF ISLAMIC BANKS IN THE UNITED KINGDOM (UK)**

### **3.1 INTRODUCTION**

#### **3.1.1 THE PAST AND PRESENT REGULATORY SYSTEM GOVERNING ISLAMIC BANKS**

#### **3.1.2 THE GOVERNMENT'S APPROACH – PRINCIPLES AND POLICIES FOR ISLAMIC BANKS**

### **3.2 LEVEL-PLAYING FIELD AND THE REGULATORY ACCOMMODATION FOR ISLAMIC BANKS**

**(a) Authorisation**

**(b) Collective Investment Scheme**

**(c) Home Purchase Plan**

**(d) Sharia Supervisory Board**

**(i) Competent Requirement**

**(ii) Relevant Experience**

**(e) Islamic Finance Cases before the English Courts**

**(f) The Regulatory Decision-Making Process**

**(g) Sharia-Compliant Liquid Assets**

**(h) Taxation**

**(i) Stamp Duty Land Tax**

**(ii) Corporation Tax**

**(iii) Value-Added Tax**

### **3.3 CONCLUSION**

### **3.1 INTRODUCTION**

As mentioned in the introductory chapter, the legal background of the UK and Malaysia is based on the English common law system and their approach to regulating the financial sector is to treat all the financial services institutions on a level-playing field basis. Nevertheless, both countries approach to regulating all financial services institutions on a level-playing field basis differs despite the fact that both are implementing English common law. For instance, it can be inferred that based on the regulatory framework governing Islamic banks in the UK, the idea to treat Islamic banks on a level-playing field represents that Islamic banks are treated within the conventional banking regulations.

The objective of this chapter is to examine the regulatory accommodation governing Islamic banks in the UK by focusing on the issue of a level-playing field in the regulatory framework and the legal impediments that have arisen in this context. This chapter analyses whether the UK's regulators have enabled a level-playing field in the regulation of Islamic banks within the conventional banking framework and examine whether 'level-playing field' regulation is a useful concept. In this regard, this chapter questions the regulatory clarity, transparency, standardisation and risks attached to Islamic banks in the existing regulatory framework.

Following the analysis made in this chapter, it is inferred that the UK level-playing field regulation governing Islamic banks is based on a reactive approach. In particular, regulatory accommodations tailored for Islamic banks are based on the real need for having a particular regulatory accommodation. This is the case, for instance, with the regulatory accommodation on liquid assets regulation, Sukuk, and taxation, which will

be explained in detail later in this chapter. Substantive compromises have been made by Islamic banks in order to fit into the conventional banking regulatory framework. Islamic banks have been exposed to several aspects of risks based on the existing level-playing field regulation such as reputational risk, transparency risk, regulatory risk, and operational risk. It is found that the level-playing field regulations for Islamic banks have not been enabled by the UK regulators.

This chapter consists of three main sections. It begins with a brief history of regulatory development in the Islamic banking sector in the UK. The second section highlights the regulatory principles adopted by the UK regulators towards Islamic banks. The third section examines and analyses the regulatory accommodation governing Islamic banks within the context of a level-playing field. The final section provides the conclusion.

### **3.1.1 THE PAST AND PRESENT REGULATORY SYSTEM GOVERNING ISLAMIC BANKS**

Historically, the regulatory system for all financial services in the UK (including Islamic banks) was based on 'tripartite system' which consists of three authorities – the Bank of England (BOE), the Financial Services Authority (FSA) and the Treasury.<sup>324</sup> These authorities were collectively responsible for managing financial stability. However, following the 2007 global financial crisis, this regulatory model was regarded to be inadequate at the institutional level. The BOE was given nominal responsibility to

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<sup>324</sup>HM Treasury, 'A New Approach to Financial Regulation: Judgement, Focus and Stability', (2010), p.3

ensure financial stability, however, it was criticised that there was no tools or levers provided to the BOE to carry its role effectively.<sup>325</sup> The Treasury which was responsible to maintain the overall legal and institutional framework were not given clear responsibility to deal with the financial crisis and the FSA was the sole regulatory body which is expected to deal with the myriad of issues, from the safety and soundness of the global investment banks to the customer practices of the smallest high-street financial adviser. It was the authoritative body which authorised and supervised all financial institutions including Islamic banks.<sup>326</sup> As a result of the financial crisis and the institutional failures, the tripartite system was abolished.

Beginning from April 2013, changes have been made in the UK's financial services landscape. The regulatory architecture in the UK is now transformed to a 'twin-peaks' model which consists of the Financial Policy Committee (FPC) where its primary duty is to maintain the financial system's stability and to consult the BOE on monetary policy; and the Prudential Regulatory Authority (PRA) which operates as a subsidiary of the BOE that is responsible for prudential regulation of all deposit-taking institutions, insurers and investment banks.<sup>327</sup> Notably, the PRA derived its objectives under the Financial Services and Markets Act 2000 which is to promote the safety and soundness of the firms it regulates to facilitate effective competition.<sup>328</sup> Finally, the Financial Conduct Authority (FCA) is an independent authority, acting as the conduct

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<sup>325</sup> Ibid., p.4

<sup>326</sup> Ibid.

<sup>327</sup> Ibid., p.5

<sup>328</sup> Prudential Regulation Authority, via <<http://www.bankofengland.co.uk/prd/>> accessed 26 July 2015

of business regulator for PRA- authorised firms.<sup>329</sup> The financial services regulation in the UK is also subject to European Union (EU) regulations.<sup>330</sup>

Prior to the changes in the regulatory architecture, as mentioned in chapter one, the latest report has revealed that at least 20 Islamic financial institutions were FSA- authorised and five of them are fully Sharia-compliant.<sup>331</sup> In 2004, the first Sharia-compliant bank in the UK was the Islamic Bank of Britain (IBB),<sup>332</sup> now rebranded as Al Rayan Bank, (hereinafter referred to as Al Rayan<sup>333</sup>), followed by the Bank of London and the Middle East (2007), Gatehouse Bank (2008), Qatar Investment Bank (UK) (2008) and Abu Dhabi Islamic Bank (2013)<sup>334</sup>. In 2012, seventeen 'Islamic windows' were established by the conventional banks.<sup>335</sup> The latest report revealed that there are now 20 international banks operating on Islamic finance in the UK.<sup>336</sup>

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<sup>329</sup> Ibid.

<sup>330</sup> The Prudential Regulations Authority's Approach to Banking Supervision, (June 2014), p.7

<sup>331</sup> The CityUK, 'The UK: The Leading Western Centre for Islamic Finance', (November 2015), p.4 See, Sharia-compliant technically means the adherence to Islamic principles. More explanation can be found in the terminology section.

<sup>332</sup> Michael Ainley, Ali Mashayeki, Robert Hicks, Arshadur Rahman, and Ali Ravalia., 'Islamic Finance', (2007), p.10, Report: The CityUK, 'Islamic Finance' (2012), p.6

<sup>333</sup> The change of name took place in December 2014 following the acquisition by Masraf Al Rayan QSC (MAR) via <<http://www.alrayanbank.co.uk/>> accessed 19 April 2015

<sup>334</sup> United Kingdom Trade & Investment, 'UK Excellence in Islamic Finance', (2014) via <<https://www.gov.uk/government/>> accessed 6 August 2015

<sup>335</sup> Supra, Note. 9. Islamic windows banks in the UK includes : ABC International Bank Ahli United Bank Bank of Ireland Barclays BNP Paribas Bristol & West Citi Group Deutsche Bank Europe Arab Bank HSBC Amanah IBJ International London J Aron & Co. Lloyds Banking Group Royal Bank of Scotland Standard Chartered UBS United National Bank. See, Report: TheCityUK, 'Islamic Finance', (2012), p.4

<sup>336</sup> Supra, Note. 334

In terms of products and services, the UK's Islamic retail bank namely Al Rayan Bank (which can be said as the sole fully-fledged Islamic retail bank) offers similar banking products as conventional retail banks. For instance, savings accounts, current accounts, home financing, debit cards, international money transfer, financial planning and other personal investment services.<sup>337</sup> Islamic wholesale banks also offer similar services to what the conventional wholesale banks offer in the financial market such as products and services for real estates, leasing, trade finance, Islamic capital markets, treasury, syndications and so forth.<sup>338</sup> However, unlike conventional wholesale banks, Islamic wholesale banks are not allowed to get involved in hedging activities such as in futures, options and other derivatives due to Sharia restrictions (the said activities involve an element of gambling and uncertainties which expose Islamic banks to high risk).<sup>339</sup> Nonetheless, the Islamic wholesale financial products are replaced with other types of contracts similar to hedging such as an Urbun contract or Salam contract<sup>340</sup> which can mitigate risk.

Thus far, since the regulatory transformation of the UK's financial services sector takes place, there is no evidence that the number of Islamic banks operating in the country has increased. However, it has been observed that the number of Islamic banking windows in operation has decreased. For example, in 2012, HSBC terminated its 'Islamic window' operation (HSBC Amanah) in most countries including the UK, except for Malaysia and Saudi Arabia. It is reported that the termination was due to their

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<sup>337</sup> Al Rayan Bank, via <<http://www.alrayanbank.co.uk/>> accessed : 10 July 2015

<sup>338</sup> See, European Islamic Investment Bank via <http://www.eiib.co.uk/html/advisory.asp>, Bank of London and Middle East via <https://www.blme.com/>, Gatehouse Bank, via <<http://www.gatehousebank.com/>> accessed: 15 July 2015

<sup>339</sup> Natalie Schoon, *Islamic Banking and Finance*, (2009), p.80

<sup>340</sup> For the definitions of Urbun and Salam, please refer to Glossary.

worldwide strategic review, which included a decision to restructure their Islamic banking business.<sup>341</sup>

This subsection has highlighted the UK's past and present regulatory system which governs Islamic banks. We now then turn to the next section that describes the government's regulatory principles for Islamic banks in the UK. This is important so as to understand the method of implementation that has shaped the regulatory accommodation of Islamic financial services in the UK. Note that, in the next section, reference to the new regulatory regime which governs the financial services industry in the UK is referred to as 'the regulators'.

### **3.1.2 THE GOVERNMENT'S APPROACH – PRINCIPLES AND POLICIES FOR ISLAMIC BANKS**

The UK's regulatory approaches for the Islamic financial sector are based on three principles- fairness, collaboration and commitment.<sup>342</sup> Fairness in the regulatory accommodation represents the avoidance of giving any special favours to one group of financial services over the others and all the regulated financial services should be able to provide benefits to UK consumers regardless of faith and beliefs.<sup>343</sup> The principle of collaboration represents the Government's objective of working together with the financial services industry and the international standards setting bodies to ensure that the Islamic financial industry could become competitive in the financial

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<sup>341</sup> HSBC Amanah via <<http://www.hsbcamanah.com/>>, and NewHorizon Magazine (Issue : Oct – Dec 2012), p.6 via <<http://www.islamic-banking.com/>> accessed: 10 September 2014

<sup>342</sup> HM Treasury, 'The Development of Islamic Finance in the UK: The Government's Perspective', (2008), p.17

<sup>343</sup> Ibid.

market. Through such collaboration, the Government has introduced legislative measures in the Finance Act 2003 to remove tax and regulatory barriers to Islamic finance in the UK.<sup>344</sup> Tax relief was introduced in transactions involving Islamic mortgages' transactions to prevent multiple payment of Stamp Duty Land Tax (SDLT) for individual consumers. The tax relief was given due to the fact that taxation incurred for some Islamic financial transactions are more expensive than for conventional financial transactions that could potentially reduce the competitiveness aspect of Islamic financial products. Further analysis of the issue of taxation is discussed in the later part of this chapter. Other legislative amendments include other equity sharing arrangements (Mudaraba, Murabaha, Diminishing Musharaka and Ijara wa Iqtina contracts) in Finance Act 2005 and in Finance Act 2006, the SDLT reliefs were extended to companies. Regulatory provisions were also made in Finance Act 2007 to facilitate the issuance of Sukuk.<sup>345</sup>

Finally, the commitment by the UK government to the Islamic financial sector is seen through the establishment of several working groups to assist the development of the sector. Although the size of the Islamic financial sector in the UK is comparatively small, the Government has established the Islamic Finance Experts' Group, the Tax Technical Working Group, an Islamic Finance team in the then FSA<sup>346</sup> and the formation of the new Islamic Finance Task Force.<sup>347</sup> The latter is primarily aimed to

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<sup>344</sup> HM Treasury, 'The Development of Islamic Finance in the UK', (2008), p.16

<sup>345</sup> Ibid., p.16, 20

<sup>346</sup> Speech: Howard Davies, 'Islamic Finance and the UK Financial Services Authority', (March 2003) via <<http://www.fsa.gov.uk/library/communication/speeches/2003/sp118.shtml>> accessed: October 2013

<sup>347</sup> News: 'Government Launches First Islamic Finance Task Force', (March 2013) via <[http://www.hm-treasury.gov.uk/press\\_20\\_13.htm](http://www.hm-treasury.gov.uk/press_20_13.htm)> accessed: 10 October 2013



promote the development of the Islamic financial sector, to increase inward investment and to strengthen the UK economy.<sup>348</sup> Due to the Government's strong interest and support for the industry, the UK is now the leading provider for Islamic financial services in the Western world.<sup>349</sup>

Be that as it may, the extent of regulations for Islamic banks in the UK (as well as in Malaysia) is also influenced by the government's public policy and political economy. As has been discussed earlier in chapter two, the UK's government's aim is to attract more investments from the Gulf region. Therefore, the extent of regulatory accommodation for Islamic banks is geared towards attracting more liquidity from Arab world. While in Malaysia, the degree of emphasis to provide more regulations for Islamic banks are essentially due to the government's aim to promote and develop the Islamic financial market and to become the leading Islamic financial centre in the world. Therefore, greater regulatory accommodation is given without necessarily based on the economic justification for regulation *per se*. As such, it can be seen in this chapter that Islamic banks in the UK are regulated not more than necessary and the regulations are provided to attract more liquidity in the financial market – not necessarily considering the substantive equality in the regulations. Moreover, as argued in chapter two, the societal sensitivity and perception can be an influential factor before a government (in this case, UK and Malaysia) choose to develop a particular sector. For the fact that the UK is a secular country, providing a greater

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<sup>348</sup> Ibid

<sup>349</sup> The CityUK, 'Islamic Finance 2013', via <<http://www.thecityuk.com/research/our-work/reports-list/islamic-finance-2013/>> accessed: 15 June 2014

emphasis on developing a sector i.e: Islamic financial sector; could trigger the sensitivity of other religions or the secular society as a whole. Ultimately, it could somewhat cause political tension in the government. Whereas in Malaysia, such an issue would not arise for it is a Muslim majority country. Additionally, the focus of the UK's government is towards attracting more liquidity in its country rather than regulating more for the 'faith' in the Islamic financial sector. In other words, the extent of regulation is also driven by political-economy factor. As such, the regulators prefer to be a neutral regulator rather than giving a special favour to a particular financial service<sup>350</sup> – in this regard, Islamic finance.

With regards to the UK's regulators approach to treat Islamic banks on a level-playing field, the idea of 'level-playing field' is rather ambiguous. There is no clear or specific indication of what 'level-playing field' actually means in the regulatory environment. It can be argued, therefore, that a general interpretation of 'level-playing field' is the idea of providing neutral treatment for all banking and financial services institutions – in terms of their products and conduct of business. Notably, Islamic financial products are decided either on a case-by-case basis, categorised differently or not regulated at all.<sup>351</sup> Also, the regulatory principle for regulation and taxation of Islamic finance is based on the economic substance of the products over their legal form.<sup>352</sup>

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<sup>350</sup> Michael Ainley, Ali Mashayeki, Robert Hicks, Arshadur Rahman, and Ali Ravalia., 'Islamic Finance', (2007), p.11

<sup>351</sup> HM Treasury, 'The Development of Islamic Finance in the UK', (2008), p.18

<sup>352</sup> Ibid., p.15

Therefore, what is assumed to be 'level' by one party may not necessarily be considered as 'level' by another party. Similarly, in the context of banking and financial services regulation, the existing regulatory accommodation, which is assumed as the level-playing field regulation for all banking and financial services institutions, may not be the most appropriate approach. This is because Islamic banks face risks that can harm the banks in different dimension than the conventional banks, as well as the challenges and realities that have been mentioned in the previous chapter. In fact, Chapter 2 has shown that the rationales and justifications for banking regulations have made the level-playing field regulations unworkable. Additionally, the regulators have also acknowledged that Islamic financial products contain different 'legal, economic or risk structures'.<sup>353</sup>

Following this, the next section examines whether the regulators have enabled a 'level-playing field' in the regulatory environment and whether level-playing field is a useful concept by analysing the regulatory framework governing Islamic banks in the UK.

### **3.2 LEVEL-PLAYING FIELD AND THE REGULATORY ACCOMMODATION FOR ISLAMIC BANKS**

This section examines and analyses the regulatory issues governing Islamic banks in the UK and the underlying problems faced by the banks within the context of a level-playing field. It consists of eight sections that include the regulatory aspects on authorisation, Collective Investment Scheme (CIS), Home Purchase Plan (HPP), Sharia Supervisory Board (SSB), Islamic finance cases before the English courts, the regulatory decision making process, Sharia-compliant liquid assets and taxation.

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<sup>353</sup> Ibid.

As argued in the previous chapter, the term level-playing field could include two main factors: (i) equality before the law and (ii) fair opportunity to compete. The following regulatory aspects are discussed in relation to these two factors.

#### **(a) AUTHORISATION**

Banking and financial services regulation requires that all banking and financial institutions in the UK be authorised in order to conduct their business and financial activities, formerly known as regulated activities.<sup>354</sup> For Islamic banks, fulfilling the authorisation requirements in the existing regulatory framework was a challenge. For instance, this was highlighted during the authorisation process for Al Rayan Bank by the then FSA.<sup>355</sup> The process required in the conventional regulatory framework poses difficulties for Islamic banks to get authorisation for their banking business in the UK as the fundamental requirement enumerated in the Regulated Activities Order requires financial institutions accepting deposits to have ‘capital certainty’.<sup>356</sup>

‘Deposit’ as defined by the Regulated Activities Order (RAO) is,

The “sum of money paid on terms under which it will be repaid, with or without interest of premium, and either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and the person receiving it, and which are

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<sup>354</sup> Section 19 Financial Services and Markets Act 2000

<sup>355</sup> Supra, Note. 350, p.14

<sup>356</sup> Art.5 (2) Financial Services and Markets Act 2000 (RAO) 2001

referable to the provision of property (other than currency) or services or the giving of security.”<sup>357</sup>

The obligation for an Islamic bank to meet the ‘capital certainty’ requirement did not align with the concept of an Islamic banking business<sup>358</sup> (the fundamental principle of Islamic finance is based on a profit and loss sharing (PLS) account (usually under Mudaraba contract). Under the Mudaraba contract, the account holders (Rabb al-mal) and the Islamic bank as the manager (Mudarib) share the profits on a pre-agreed basis and the loss is borne by the Rabb al-mal. The Mudarib accepts the risk of any loss only as a result of their misconduct, negligence or breach of any conditions under Mudaraba.<sup>359</sup> Thus, in principle, due to the PLS model the depositors owned the risk of not being able to obtain their deposits.<sup>360</sup> However, for an authorisation to be granted an assurance has to be made by an Islamic bank to the regulator whereby depositors are entitled to full repayment in order to fulfil the requirement of ‘banking business.’<sup>361</sup>

Such practice, nevertheless, contradicts the principles of PLS in Islamic finance. The capital certainty requirement is a challenge in an Islamic financial environment due to the PLS model, because the rate of return in Islamic financial assets is not known and

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<sup>357</sup> Ibid.

<sup>358</sup> Andrew Henderson, ‘Islamic Financial Institutions’ in Craig R. Nethercott and David M. Eisenberg, *Islamic Finance: Law and Practice* (2012), p.69

<sup>359</sup> Ibid.,

<sup>360</sup> Ibid.

<sup>361</sup> Supra, Note. 339, p.14

not fixed as opposed to the conventional system where the rate of return is predetermined or fixed.<sup>362</sup>

This raises the question of a level-playing field in the regulations, in particular; conventional banking and financial services regulation does not fully enable Islamic banks to operate based on the PLS model. Arguably, this has caused some inequality at the substantive level in the regulation. (As argued in the previous chapter, equality before the law comprises of two other elements, (i) formal equality (ii) substantive equality). This is because Islamic banks have to compromise their principles to fit into the conventional banking and financial services regulatory requirements. Ultimately, the outcome of this regulation highlights the fact that conventional regulatory practice and Islamic banking principles do not always fit.

As argued earlier, when the regulation does not fully enable Islamic banks to practice PLS in their banking business, Islamic banks have to compromise their principles to fit into conventional regulatory practice because an inequality at the substantive level exists. To solve the said issue, therefore, Al Rayan established a profit-stabilisation reserve (PSR) to fulfil the deposit repayment guarantee. The PSR is aimed 'to smooth the volatility in the profit payments that are provided by the bank'<sup>363</sup> and the fund of this reserve means 'a deduction made by the bank from the gross profit after deducting

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<sup>362</sup> V.Sundarajan and Luca Errico, 'Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead', (2002), Annex 1

<sup>363</sup> Ibid.

the bank's share.'<sup>364</sup> The fund of the PSR is also used by the bank when the investment does not generate profit or makes losses<sup>365</sup>.

Another example where the regulation does not enable Islamic banks to practice its original business model is in the case of the Deposit Guarantee Scheme. In the UK, consumers of authorised financial firms are protected through the Deposit Guarantee Scheme Directive (DGSD) by virtue of the FSMA 2000. The purpose of DGSD is to reimburse the depositors up to a certain 'ceiling' in the event that the bank is facing lack of liquidity has stopped trading or is in default. The DGS ceiling amount is £85,000 for deposits and £50,000 each for investments and home finance.<sup>366</sup> Therefore, in the UK, Islamic banks can only pass on losses to its account holders only after the bank has announced the loss and there is an express agreement by the account holder of his desire to bear the losses for religious reasons.<sup>367</sup>

Al Rayan Bank is legally bound to offer a deposit repayment guarantee to the depositors.<sup>368</sup> However, DGS funds are invested in interest-bearing accounts<sup>369</sup> which ultimately oblige Islamic banks to invest in the conventional pooled fund. Islamic banks are therefore exposed to non-Sharia-compliant activities and the DGS requirements also mean that Al Rayan and any other Islamic banks are not allowed to

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<sup>364</sup> Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A comparative look at the United Kingdom and Malaysia*, (2011), p.159

<sup>365</sup> Islamic Bank Britain, Clause 8.3 (b) Direct Savings Account Special Conditions

<sup>366</sup> Financial Services Compensation Scheme via <<http://www.fscs.org.uk/>> accessed: 5 April 2015

<sup>367</sup> Supra, Note. 202, p.62

<sup>368</sup> Sharia Compliant Islamic Savings Products via <<http://www.alrayanbank.co.uk/>> accessed: 5 April 2015

<sup>369</sup> Financial Services Compensation Scheme via <<http://www.fscs.org.uk/>> accessed: 5 April 2015

practice their PLS model. For instance, Al Rayan Bank needs to opt for Qard principle (loan) equivalent to conventional current account concept which means that the current account is regarded as a loan to the bank, which is used by the bank for investment and the deposit is returned to the depositor on demand.<sup>370</sup>

Notably, the type of Islamic banking accounts which offer a PLS model is on current accounts, Mudaraba (partnership agreement) or Wakala (agency agreement) structure (where it implies that profits are share between the bank and the depositors on the basis of a contractually agreed profit ratio, and losses are distributed in accordance with the proportion of capital provided).<sup>371</sup> For Al Rayan Bank in the UK, Wakala structure is used for the savings accounts. Al Rayan Bank uses the term called 'Fixed Term and not 'Fixed Return' where the bank provides "an expected profit rate over a set period of time as a set period of time as a 'target' based on the investment activity it will undertake with the deposits."<sup>372</sup> For example, two years of the Two Years Fixed Term Deposit Account. Under this arrangement, Islamic banks cannot guarantee a fixed return like the conventional banks do (because in investment there is always an element of risk).

This sort of compromise has prevented Islamic banks from implementing their Islamic financial model. In this regard, the question of a level-playing field arises concerning the substantive equality in the law itself. Although there is formal equality in the law (where all the banks should obey the requirements of offering deposit repayment

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<sup>370</sup> Al Rayan Bank, via <<http://www.alrayanbank.co.uk/media/244556/pb1499-al-rayan-personal-banking-lft.pdf>> accessed: 10 June 2015

<sup>371</sup> Supra, Note. 339, p.62

<sup>372</sup> Al Rayan Bank, via <<http://www.alrayanbank.co.uk/>> accessed: 10 June 2015



guarantees), nevertheless, at the substantive level of the law there is a lack of fairness for Islamic banks, because the fundamental theory of Islamic finance could not be fully implemented in practice. This could ultimately impede Islamic banks from developing.

While such regulatory obligation is in conflict with the salient feature of Islamic finance, which is based on the PLS principle, Islamic banks have the option of notifying depositors, who are adhering strictly to Sharia rules, of turning down deposit protection on religious grounds and opting for the risk-sharing formula in order to comply with Sharia principles. For Al Rayan, the refusal to turn down deposit protection is regarded as a non-Sharia-compliant act.<sup>373</sup> In other words, should the depositor accept Al Rayan's offer of the deposit repayment guarantee, the act is considered as non-Sharia compliant, because it goes against the Sharia-based PLS principle that the depositor should accept some risk of loss.<sup>374</sup> This practice would not have happened if Islamic banks in the UK were they able to channel the DGS fund to a separate entity that invests only in Sharia-compliant activities - similar to the Malaysian approach. In Malaysia, DGS funds for Islamic banking depositors are channelled separately under the Malaysian Deposit Insurance Scheme (MDIC) establishment. This establishment is mentioned further in the next chapter.

With regards to the authorisation of Islamic banks, the categorisation of an Islamic bank as a deposit-taking business also conflicts with the inherent nature of Islamic banking business. In the regulatory framework, an Islamic bank is regarded as a

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<sup>373</sup> Islamic Bank Britain, Clause 8.5 Direct Savings Account Special Conditions

<sup>374</sup> Simon Archer and Rifaat Ahmed Abdel Karim, 'Profit-sharing investment Accounts in Islamic Banks: Regulatory Problems and Possible Solutions', (2009), p.303

depository institution - whereas the salient feature of Islamic financial transactions is based on profit sharing.<sup>375</sup> The fact that Islamic banks are operating on equity-based transactions in their deposit-taking business raises an issue of whether Islamic banks should be authorised as investment banks (i.e non-depository institutions) rather than depository institutions.<sup>376</sup> Nevertheless, to define deposit-taking Islamic banks as investment banks is also problematic since investment banks do not conduct deposit-taking at the retail level. The task of appropriately defining an Islamic financial institution, which undertakes deposit taking business is, therefore, rather tricky and this ultimately raises concerns when Islamic banks are regulated in the existing framework. It is, however, beyond the scope of this chapter to discuss the issue of categorising Islamic banks.

While the capital certainty requirement obliges Islamic banks in the UK to invest in conventional pooled funds like DGS, which is non-Sharia compliant, the remaining issue is whether or not a capital certainty requirement should be imposed on Islamic banks. Simon Archer and Rifaat Abdul Karim argue that, in order to promote the development of Islamic finance, an Islamic bank should not be obliged to offer 'capital certainty'.<sup>377</sup> Instead of imposing the capital certainty requirements for Islamic banks, the scholars have suggested that a fund management entity should be established as a subsidiary of the retail bank or a fellow subsidiary of a holding company. This entity will be acting as Mudarib that manages the investment account holder (IAH) funds. The IAH funds are divided into two types: restricted and unrestricted. For the

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<sup>375</sup> Simon Archer and Rifaat Ahmed Abdel Karim, 'Corporate Governance, Market Discipline and Regulations of Islamic Banks', (2006), p.2

<sup>376</sup> Supra, Note. 374

<sup>377</sup> Ibid., p.306

unrestricted IAH, 'the funds are invested at the bank's discretion, normally in the same asset pool as that in which the bank's own funds and those from current accounts are placed.'<sup>378</sup> On the other hand, for the restricted IAH, 'the funds of the restricted IAH are invested in asset pools that are separately designated and distinct from the bank's own funds and thus do not appear in the bank's balance sheet.'<sup>379</sup>

Should the UK's financial regulator, however, choose not to impose a capital certainty requirement for Islamic banks; an issue with regard to the fair opportunity for Islamic banks to compete alongside conventional banks would arise. This is because such a policy could expose investors to the risk of loss in regards to their investment. The consequence of the insecurity that this would create may be contrary to the objective of the UK's financial regulator – which is to create investor confidence in the financial market.<sup>380</sup> On top of that, the present suggestion by Archer and Karim contradicts their earlier paper where they admitted that:

“in so far as IAH have deposited their funds in the bank rather than investing them in a collective investment scheme, the expectation would be that if IAH are paid no returns on their investments or low returns compared to the market return of similar instruments and are made to bear the risk of loss, they may start a run on the bank to withdraw their funds.”<sup>381</sup>

It is, indeed, inarguable that, as stated in their earlier work, a bank-run could happen should the IAH's returns be lower than the conventional market or they are made to

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<sup>378</sup> Supra, Note. 374

<sup>379</sup> Ibid.

<sup>380</sup> Article 3, Financial Services and Markets Act 2000

<sup>381</sup> Supra, Note. 374, p.13

bear the risk of loss. As a result, a bank's solvency may be threatened and systemic risk may be triggered, which can lead to a financial crisis. While the fund management entity suggested by Archer and Karim can be regarded as an innovative approach to help Islamic banks to practice their PLS model, the proposed establishment of a subsidiary of the retail bank or a fellow subsidiary of a holding company could not ensure that the IAH funds would be well managed.

Although PSR was established to overcome the issue of capital certainty requirements, the market discipline of an Islamic bank is not necessarily ensured. For instance, the 'profit share' paid to the unrestricted IAH is 'the outcome of a process of earnings management and accounting manipulation that seeks to shadow the rates of return paid by conventional banks on their retail deposits.'<sup>382</sup> Hence, shareholders have to agree to the risk that part or all of their profits will be displaced to accommodate the returns for the IAH. This risk management system is devised to avoid attracting the attention of the banking regulators and to reduce the danger of a bank run.<sup>383</sup>

In sum, the existing conventional regulatory framework (which is seen as representing formal equality) has led Islamic banks to make certain compromises in order to fulfil the regulatory requirements. This could expose Islamic banks to operational risk as

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<sup>382</sup> Supra, Note. 374, p.303. IAH under Mudaraba consists of two accounts – restricted and unrestricted investment. The restricted IAH funds "are invested in asset pools that are separately designated and distinct from the bank's own funds and thus do not appear in the bank's balance sheet." See, Supra, Note. 375, p.2

<sup>383</sup> Supra, Note. 375, p.8

well as reputational risk as they are unable to implement the Islamic financial model.<sup>384</sup> Therefore, due to the existing regulatory requirement for Islamic banks it can be argued that there is a lack of equality at the substantive level in the existing regulatory framework. The positive aspect of the existing regulation, however, is that Islamic banks have a fair opportunity to compete with their conventional counterparts when they are required to have capital certainty like all other banks as it promotes financial stability and depositor protection. Nonetheless, it has also been argued that the issue of reputational risk should be given due attention by the regulators for the sector's survival and growth.<sup>385</sup>

Perhaps, the Malaysian approach of having a separate Islamic deposit insurance scheme could be considered by the UK's regulators, but one may also argue that the latter suggestion could not be implemented at present as the number of Islamic banks in the UK is comparatively small. This argument may also lead to the question of what is considered as an adequate number of UK Islamic banks in order to establish a separate deposit insurance scheme for them. The latter issue, however, is not going to be discussed further in this thesis. We now turn to the next section, which discusses

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<sup>384</sup> Operational risk is defined by Basel II as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events." (Basel II, 'Operational risk', (2001), p.18). Basel II includes legal risk as part of operational risk while reputational risk is excluded from this definition. Reputational risk is, however, can be considered to be the outcome of operational risk. Reputational risk can be described as the current or prospective risk to earnings and capital arising from the failure to meet stakeholders' reasonable expectations. See, Zamir Iqbal, Abbas Mirakhor, Hossein Ashari, *New Issues in Islamic Finance and Economics: Progress and Challenges*, (2009), p.151). For instance, controversial products and services offerings by Islamic banks can expose the latter to reputational risk.

<sup>385</sup> Zamir Iqbal, Abbas Mirakhor, Hossein Ashari, *New Issues in Islamic Finance and Economics: Progress and Challenges*, (2009), p.149-150

the issues in the Collective Investment Scheme regulation within the context of a level-playing field.

## **(b) COLLECTIVE INVESTMENT SCHEME (CIS)**

As the Islamic banks in the UK are governed within the conventional regulatory framework, the issue of regulatory definition in the CIS represents another challenge for Islamic banks, in particular in relation to Islamic financial contracts. The broad regulatory definition of CIS in relation to the most widely used Islamic financial contracts shows the uncertainty in the regulation which ultimately questions the usefulness of the level-playing field regulations. Three examples of widely used Islamic financial contracts are provided below to highlight the issue. They are Mudaraba, Musharaka and Sukuk.

Firstly, the characteristics of a Mudaraba contract could fall within the broad definition of the Collective Investment Scheme (CIS). CIS is defined as;

“any arrangements with respect to property of any description (including money), the purpose or effect of which is to let investors participate in the profits or income arising from that property (whether by becoming owners of that property or otherwise).”<sup>386</sup>

In the CIS regulation, the participants in the scheme must not have any ‘day-to-day’ control over the management of the property, whether or not they have the right to be consulted or to give directions.<sup>387</sup> Such arrangements must also have either or both of the following characteristics:-

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<sup>386</sup> Michael Blair and Andrew Henderson (eds), *Blackstone’s Guide to the Financial Services and Markets Act 2000*, (2009), p.200

<sup>387</sup> Section 235 (2) Financial Services and Markets Act 2000

- (a) The contributions of the participants and the profits or income out of which payments are to be made to them are pooled;
- (b) The property is managed as a whole by or on behalf of the scheme.<sup>388</sup>

In Mudaraba, it can be argued that its mode of transaction could fall within the arrangement under the CIS. Therefore, the classification of an arrangement as a CIS means that those establishing and operating the arrangement would need to be PRA authorised.<sup>389</sup>

While Mudaraba could fall under the CIS arrangement, Mudaraba could also fall within the provision of 'accepting deposits' under the Regulated Activities Order (RAO)<sup>390</sup>. Thus, classifying Mudaraba within the provision of the RAO would exclude Mudaraba from the definition of a CIS on the basis that 'they are pure deposit-based schemes within the meaning of paragraph 3 of the Schedule to the Treasury CIS Order.'<sup>391</sup>

The practice is that the regulator and an Islamic bank conduct discussions to decide the most accurate category for a specified investment that suits the commercial nature of the product or service that an Islamic bank wishes to offer. In practice, the approach often taken by an Islamic bank is to apply for both categories in seeking authorisation from the regulator.<sup>392</sup> From such practice, it can be deduced that regulatory

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<sup>388</sup> Section 235 (3) Financial Services and Markets Act 2000

<sup>389</sup> It was then the Financial Services Authority. See, Michael Blair, 'Islamic Financial Services' in Michael Blair, George Walker, Robert Purves (eds), *Financial Services Law*, (2009), p.1009

<sup>390</sup> The FSMA 2000 (Regulated Activities) Order 2001 via

<<http://www.legislation.gov.uk/ukxi/2001/544/article/5/made>> accessed: 5 September 2013

<sup>391</sup> Supra, Note. 389, p.1011

<sup>392</sup> Supra, Note. 358, p.69-70

uncertainties have been caused when treating Islamic banks in the conventional regulatory framework.

The issue of regulatory uncertainties in CIS arrangements also arises in the case of Musharaka contracts. The characteristics of Musharaka could also fall within the CIS arrangement depending on the nature of the arrangement. Generally, Musharaka satisfies the 'arrangements', 'property' and 'purpose of effect' conditions and the 'pooling' or 'management as a whole' condition in the Financial Services and Markets Act 2000. Arrangements such as trade financing and the element of 'day-to-day' control are, however, a question of fact in a Musharaka contract. For instance, the management of a Musharaka contract or diminishing Musharaka may be undertaken jointly by an Islamic bank and the client. The parties to the contract may argue, therefore, that 'day-to-day' control remains with both parties. As such, the arrangement is not a CIS.<sup>393</sup> In certain arrangements, a Musharaka contract could fall within the CIS exclusion order such as 'schemes entered for commercial investment purposes related to existing business.'<sup>394</sup>

Sukuk<sup>395</sup> arrangements are another Islamic financial instrument which could fall within the wide definition of CIS. Sukuk is often treated in a similar way to the conventional bond, however it is in fact a participation certificate that entails an undivided ownership interest in the underlying asset such as 'tangible assets, usufruct and services or (in

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<sup>393</sup> Ibid.

<sup>394</sup> Ibid.

<sup>395</sup> Sukuk (a plural noun in Arabic literally means 'certificates' and singular meaning: Sakk)



the ownership of) the assets of particular projects or special investment activity.<sup>396</sup> Sukuk must involve the transfer of assets to Sukuk holders which entitle them to earn a return from those assets.<sup>397</sup> It is a form of security, which involves the sale-repurchase of tangible assets via a special purpose vehicle (SPV).<sup>398</sup> On the other hand, conventional bonds are a simple debt instruments that entail a debt owed by the issuer to the bondholders.

Bondholders have 'no direct interest in any underlying assets of the issuer and they are merely creditors of the issuer earning interest on the debt owed to them by the issuer.'<sup>399</sup> Sukuk is otherwise termed by the regulator as the 'Alternative Finance Investment Bond' (AFIB) and 'alternative debentures' in the FCA/PRA Handbook – in order to reflect the neutrality of its treatment. Notably, the UK Government has issued its first sovereign Sukuk worth £200 million, which is set to mature in the year 2019.

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Regulatory uncertainties also arise when Sukuk are regarded as a CIS. According to the regulator, due to the broad regulatory definition of CIS, some Sukuk were treated as CIS while some were excluded from CIS.<sup>401</sup> There are no examples given by the

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<sup>396</sup> Sharia Standard No.17 – Investment Sukuk, Accounting, Auditing & Governance Standards (AAOIFI), (2010), p.586

<sup>397</sup> Julian Johansen and Atif Hanif, 'Sukuk' in in Craig R. Nethercott and David M.Eisenberg, *Islamic Finance: Law and Practice*, (2012), p.259

<sup>398</sup> Rodney Wilson, Legal, Regulatory and Governance Issues in Islamic Finance, (2012), p.166

<sup>399</sup> Supra, Note. 259

<sup>400</sup> 'Government Issues First Islamic Bond' via <<https://www.gov.uk/government/news/government-issues-first-islamic-bond>> accessed: 10 Jun 2014

<sup>401</sup> HM Treasury, 'Consultation on the Legislative Framework for the Regulation of Islamic Finance Bond (Sukuk)', (2008), p.19

regulator, however, on the type of Sukuk that could be treated as CIS or otherwise. Nevertheless, the regulatory accommodation has meant that the Sukuk issuers were subject to a wider range of controls and authorisation was needed; whereas the parties to conventional securities were not. As a result of that, there could be marketing and promotion of Sukuk that ultimately placed the Sukuk issuers at a competitive disadvantage.<sup>402</sup> The arrangement was also considered as inappropriate, because Sukuk instruments comprise similar economic characteristics and risk profiles to conventional bonds or asset backed securities.<sup>403</sup> Additionally, the regulators believed that the regulatory accommodation for Sukuk as a CIS or RAO ('instruments creating' or 'acknowledging indebtedness') may be overlapping as Sukuk arrangements can fit into either the CIS or RAO categories.

To overcome the issue above, the regulator introduced legislative amendments. The aim of the legislative amendment was to ensure that Sukuk are treated in a similar way to existing financial products with similar economic characteristics and subject to proportionate regulatory treatment with conventional bonds.<sup>404</sup> The objective of the legislative changes was to provide clarity in the regulatory treatment and compliance costs for Sukuk so as to facilitate Sukuk issuance in the UK. Furthermore, it can be argued that the legislative amendment could also be regarded as a representation of the regulator's effort to provide a level-playing field for the Islamic financial sector. The legislative amendments are incorporated in FSMA 2000 (Collective Investment

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<sup>402</sup> HM Treasury, 'Government Sterling Sukuk Issuance: A response to the Consultation', (2008), p.33

<sup>403</sup> Supra, Note. 401

<sup>404</sup> Ibid.

Schemes) Order 2001 and a new specified investment provision is created in Article 77A (1) and Article 78 (2) of the RAO.<sup>405</sup>

Treating Sukuk within the RAO rendered Sukuk as 'instruments acknowledging indebtedness' and subject to the 'Debt Issues' exclusion in the Treasury CIS Order.<sup>406</sup> This led to the creation of a category of specified investment in the Finance Act 2005 for tax purposes (Section 48A – where Sukuk are named as Alternative Finance Investment Bonds [AFIBs]). The content of Section 48A is the same as Article 77A (1) of the RAO.<sup>407</sup> Sukuk are, therefore, viewed as fitting better under FSMA 2000 and Sukuk are now, consequently, excluded from the definition of a CIS.<sup>408</sup> The consequence of excluding Sukuk within the Treasury CIS Order meant Sukuk would be treated as 'specified investments' for RAO purposes and anyone carrying on a regulated activity with respect to Sukuk would require the regulator's authorisation with respect to 'debentures' ('alternative debentures') to avoid breaching the General Prohibition under FSMA 2000.'<sup>409</sup>

One positive aspect of a level-playing field in the existing regulation can be inferred when the UK government stipulated that Sukuk, if they are a public debt, should also be subjected to listing requirements.<sup>410</sup> In the UK, Sukuk are listed by the United Kingdom Listing Authority (UKLA) and any entity that wishes to list a Sukuk must

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<sup>405</sup> Supra, Note. 401, p.18

<sup>406</sup> William Blair, 'Islamic Financial Services' in Islamic Financial Services' in Michael Blair, George Walker, Robert Purves (eds), *Financial Services Law*, (2009), p.1016

<sup>407</sup> Ibid.

<sup>408</sup> Ibid.

<sup>409</sup> Ibid., Art.21 FSMA 2000

<sup>410</sup> Art. 78 FSMA 2000

acquire the UKLA's approval.<sup>411</sup> The rationale for the listing requirement is that if the CIS is exploited by the instrument, which is supposed to be classified as a CIS ('i.e. the risk that the exclusion from being classified as a collective investment scheme is exploited by instruments not intended to be excluded'), the instruments will still be listed in an official list or traded on a regulated market or recognised investment exchange. The intention was to avoid regulatory arbitrage and to enhance the level of transparency and consumer protection.<sup>412</sup>

In the current regulatory framework, however, not all Sukuk are accommodated in the new legislative changes – only those that are structured to have similar economic characteristics to conventional debt instruments.<sup>413</sup> In other words, only those arrangements that grant, in substance, debt-like returns are captured. The regulatory accommodation for Sukuk in the UK is therefore decided on a case-by-case basis.<sup>414</sup> In this regard, the approach taken by the regulator is to focus on the substance of the transaction of Sukuk rather than its form. For example, the regulatory accommodation of Sukuk is based on the context of a Sukuk transaction and whether it fits with the definition in the provision. The definition of AFIB in Section 48A of the Finance Act 2005 and the RAO would cover Sukuk, if the arrangement replicated the circumstances for a conventional debt security. If the arrangement does not replicate the circumstances for a conventional debt security, the definition does not include

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<sup>411</sup> Michael Ainley, Ali Mashayeki, Robert Hicks, Arshadur Rahman, and Ali Ravalia., 'Islamic Finance in the UK: Regulation and Challenges', (2007), p.26

<sup>412</sup> Financial Conduct Authority Handbook, PERG2 – 2.6.11GG

<sup>413</sup> HM Treasury, 'Legislative Framework for the Regulation of Alternative Finance Investment Bonds (Sukuk)', (2009), p.7

<sup>414</sup> Supra, Note. 401, p.19

Sukuk, because the risks and rewards under Sukuk were not equivalent to a conventional bond.<sup>415</sup>

Although the regulator's effort could somehow be seen as an attempt to create a more level-playing field for the Islamic financial sector through the legislative amendment, nevertheless, inequality at the substantive level still exists. Since Sukuk are decided on an individual basis, the current regulatory accommodation may pose regulatory uncertainties as the same type of Sukuk issued by different Islamic financial institutions could possibly be treated differently by the regulator. Moreover, not all Sukuk transactions could be treated in a similar manner as the conventional bond due to the fact that some Sukuk contain distinctive underlying legal structures from the conventional bond.<sup>416</sup> For instance, the mode of transaction in Sukuk-al Ijara is distinct from a conventional bond.<sup>417</sup> Arguably, this issue should not create problems, if the regulator has a full understanding of how every type of Sukuk operates. It is therefore crucial for the regulators to give more attention to particular risks attached to Sukuk, although it is not necessary to have different regulatory treatment.

In sum, it can be inferred that based on the legislative amendment for Sukuk, the regulator has made an attempt to provide a more level-playing field for the Islamic financial sector in the UK. On the one hand there is a positive implication for the regulatory treatment of Sukuk, which represents the element of equality before the law (formal equality – through the legislative amendment). On the other hand, there is still

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<sup>415</sup> Supra, Note. 406, p.1017

<sup>416</sup> Supra, Note.401, p.19

<sup>417</sup> Jonathan Ercanbrack, (PhD Thesis): *The Law of Islamic Finance in the UK: Legal Pluralism and Financial Competition*, (2011), p. 286

a lack of regulatory certainty at the substantive level (when not all Sukuk are regulated based on its nature). It can also be argued, however, that while the legal uncertainty exists, the level-playing field regulation does not necessary need to have separate regulation when the economic substance is the same, for the reason that extra cost would be incurred.

The next section discusses the lack of regulatory clarity involving the HPP regulation and the model of Islamic financial contracts. It highlights the regulatory problems with regards to a level-playing field within the conventional regulatory framework.

### (c) HOME PURCHASE PLAN (HPP)

This section questions the clarity in the regulatory definition provided in the HPP regulation. This issue involves three Islamic financial contracts commonly used for Islamic mortgage arrangements. These are - the Ijara contract, Diminishing Musharaka contract and Murabaha contract. The diagrams below represent Islamic mortgages.

*Ijara*

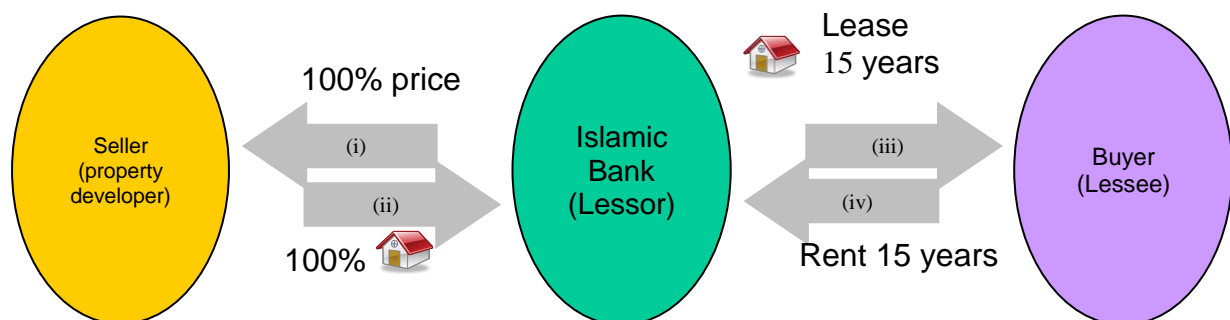


Figure 1:

Source: Author's own

The diagram above shows the Ijara transaction.

- (i) The Islamic bank purchases the house from the Seller with full payment.
- (ii) The house is transferred to the Islamic bank together with the ownership.
- (iii) The Islamic bank leases the house to the buyer for a fixed rent over a fixed period (e.g 15 years).
- (iv) The buyer pays the monthly rent to the Islamic bank. Note that simple Ijara does not transfer the ownership to the buyer.<sup>418</sup>

### *Diminishing Musharaka*

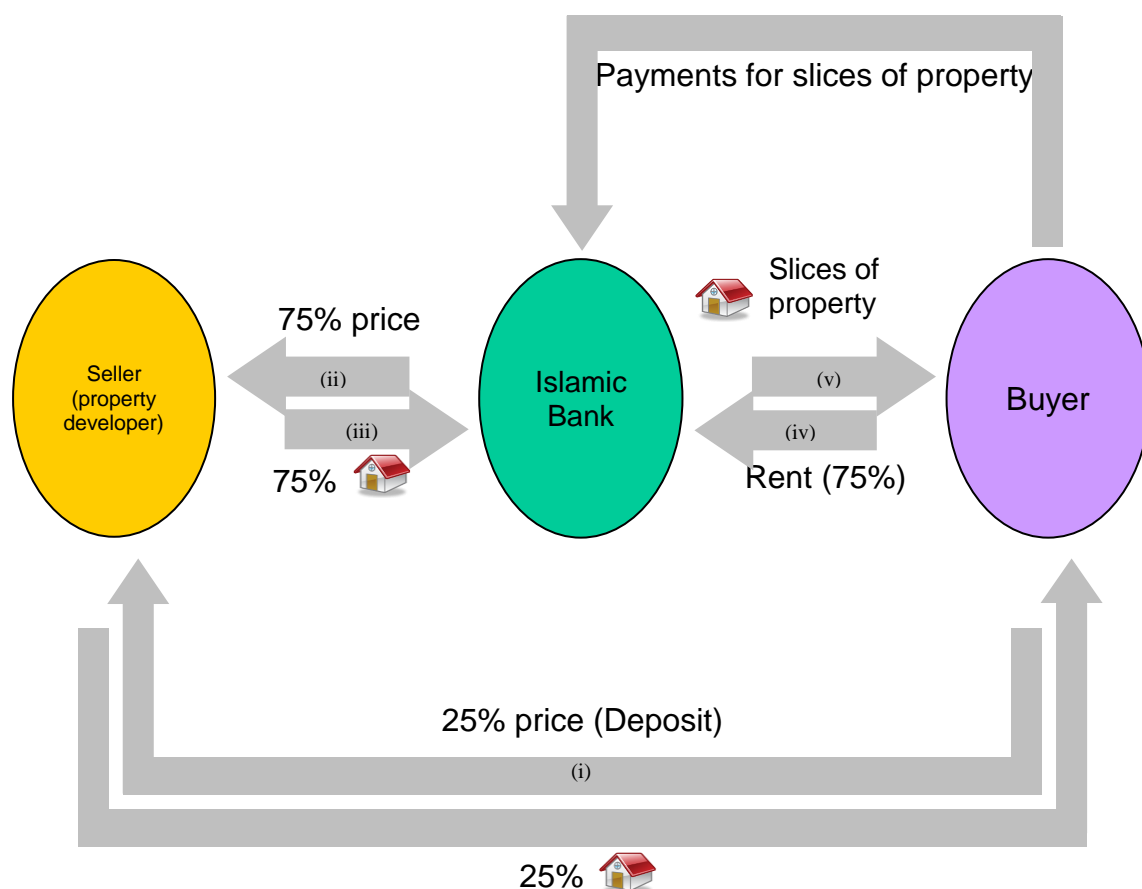


Figure: 2

Source: Amin<sup>419</sup>

<sup>418</sup> Ken Eglinton, Nash Jaffer, Armughan Kausar, and Alkis Michael, 'Accounting and Taxation Implications of Islamic Finance Products' in Craig R. Nethercott and David M. Eisenberg, *Islamic Finance: Law and Practice*, (2012), p.95

<sup>419</sup> Mohammed Amin, via <<http://www.mohammedamin.com/>> accessed: 10 October 2013

The diagram above showed the Diminishing Musharaka transaction.

- (i) The buyer identifies the house and paid 25% deposit to the property developer.
- (ii) The Islamic bank purchases the house for the remaining price (75%) and shares ownership with the customer.
- (iii) The property is transferred to the Islamic bank with the bank's share.
- (iv) The buyer pays rent a for slices of the property and the buyer's share increases every time the rent is paid and concurrently the Islamic bank's share declined.
- (v) Upon the full payment of rent (which includes the principal + profit), the buyer has full ownership of the house. Note that the Diminishing Musharaka transaction is identical to the conventional loan arrangement.

### *Murabaha*

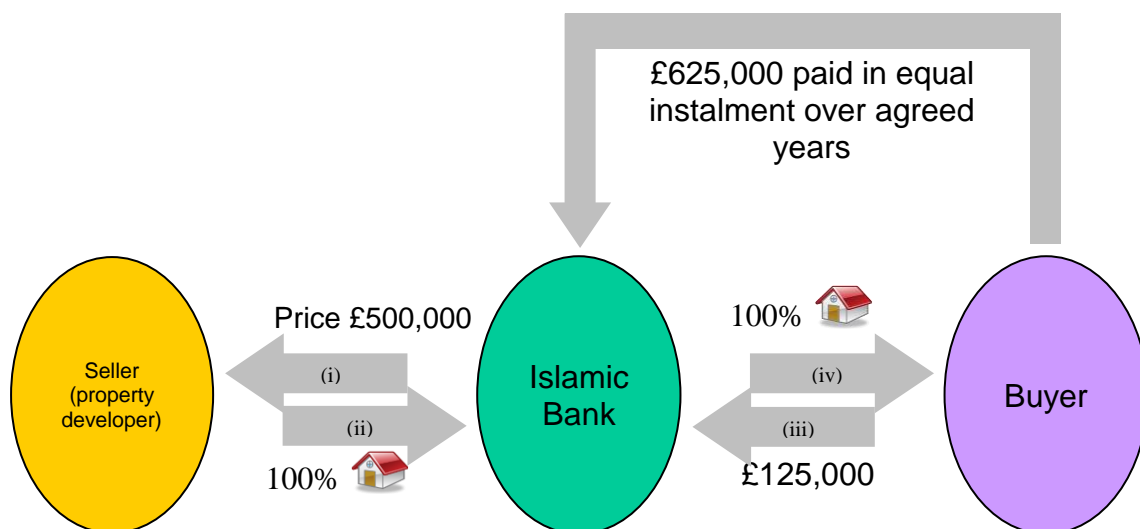


Figure 3

Source: Amin

The diagram above shows the Murabaha contract.

- (i) The Islamic bank pays the seller the cost-price (e.g: £500,000) on a spot basis.
- (ii) The Islamic bank gets the ownership of the house.



(iii) The Islamic bank immediately sells the same asset to the buyer at cost + profit.

(e.g: £ 500,000 + £125,000= £625,000).

(iv) Title of the house is passed to the buyer.

Islamic mortgage arrangements were accommodated in the Home Purchase Plans (HPPs) under the Finance Act 2007.<sup>420</sup> The legal accommodation is to give the customers of an Islamic finance mortgage the same level of protection as the customers of conventional mortgages.<sup>421</sup>

The level-playing field in the regulation causes lack of regulatory certainty where the characteristics contained in two different Islamic financial contracts could fall within the HPP RAO broad regulatory definition. For example, the Ijara contract and the Diminishing-Musharaka contract should fall within the definition of HPP.

RAO defined HPP<sup>422</sup> as:

An arrangement comprised in one or more instruments or agreements which meets the following conditions at the time it is entered into:

(a) the arrangement is one under which a *person* (the 'home purchase provider') buys a *qualifying interest in land* or an undivided share of a *qualifying interest in land*;

(b) where an undivided share of a *qualifying interest in land* is bought, the interest is held on trust for the home purchase provider and the individual or trustees in (c) as beneficial tenants in common;

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<sup>420</sup> 'Home Purchase Plans' via <<http://www.fca.org.uk/firms/>> accessed: 1 September 2015

<sup>421</sup> Ibid.

<sup>422</sup> Article 63 (F) Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No.2) Order 2006

(c) the arrangement provides for the obligation of an individual or trustees (the *home purchaser*) to buy the interest bought by the home purchase provider during the course of or at the end of a specified period; and

(d) the *home purchaser* (if he is an individual) or an individual who is a beneficiary of the trust (if the *home purchaser* is a trustee), or a related person, is entitled under the arrangement to occupy at least 40% of the land in question as or in connection with a dwelling during that period and intends to do so.

Following this, an Islamic bank has to determine the exact type of home financing product they wish to enter into with the customer in order to apply for the appropriate role; either as a home purchase provider or administering an HPP.<sup>423</sup>

Moreover, for an Ijara contract, it can also be argued that the arrangements did not fall within the definition of 'regulated mortgage contract' – as the Ijara arrangement entailed the ownership of the property remaining with the Islamic bank for a specified term Ijara until the customer made the full payment.<sup>424</sup>

As for the Murabaha contract, which is also often used in home mortgage financing, the arrangement does not fall within the scope of HPP as it does not involve the homeowner buying the property from the Islamic bank on deferred payment terms. Thus, Murabaha contracts should fall within the scope of a 'regulated mortgage contract'. Based on the existing regulatory accommodation, an Islamic bank needs to

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<sup>423</sup> Ibid. Also see, Andrew Henderson, 'Islamic Financial Institutions' in Craig R. Nethercott and David M. Eisenberg, *Islamic Finance: Law and Practice* (2012), p.73

<sup>424</sup> Andrew Henderson, Ibid., p.72

apply for permission in respect to HPPs and 'regulated mortgage contracts' under FSMA 2000 Part XV,<sup>425</sup> which provides:-

- (a) a 'regulated mortgage contract' means a contract under which—
  - (i) a person ('the lender') provides credit to an individual or to trustees ('the borrower'); and
  - (ii) the obligation of the borrower to repay is secured by a first legal mortgage on land (other than timeshare accommodation) in the United Kingdom, at least 40% of which is used, or is intended to be used, as or in connection with a dwelling by the borrower or (in the case of credit provided to trustees) by an individual who is a beneficiary of the trust, or by a related person.

There is also a lack of regulatory clarity in the existing regulation with regards to Ijara and Diminishing Musharaka contracts. These contracts are accommodated separately in the FCA/PRA Handbook although the actual practice differs.<sup>426</sup> For example, Al Rayan Bank uses a Diminishing Musharaka contract as a first transaction and an Ijara contract as the second transaction.

The steps are illustrated as follows:-

- (i) Al Rayan Bank will agree to sell its share of the property to the customer at an agreed monthly amount over a fixed period (known as the term). The customer's share in the property increases with every monthly payment made towards acquiring Al-Rayan Bank's share in the property.

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<sup>425</sup>Ibid., p.73. See, Article 61 (3) (a) Financial Services Markets Act 2000 (Regulated Activities) Order 2001

<sup>426</sup> Islamic Bank of Britain Product Information Booklet via <<http://www.islamic-bank.com/>> accessed 10 September 2013

- (ii) Second, the shares of the mortgage are leased through an Ijara contract. Al Rayan Bank will then agree to lease its share in the property to the customer for which the customer will pay a monthly rent. The customer's HPP payment is therefore made up of two elements, an acquisition payment and a rental payment. As the customer's make monthly payments, the customer's share in the property increases as Al Rayan Bank's share gets smaller and although the customer's monthly payments remain constant (subject to quarterly reviews) the rental payment element will decrease whilst the customer's acquisition payment element increases. These two steps are used concurrently. In other words, Al Rayan used Ijara and Diminishing Musharaka as two contractual elements of a single transaction<sup>427</sup> whereby the customer and Al Rayan Bank contribute towards the purchase or refinance of the house as partners.

On the other hand, the regulator's illustration in its Handbook reflects two different products offered by an Islamic bank.

Below is the diagram provided by the regulator on Ijara and Diminishing Musharaka arrangements. The regulator states that two types of home purchase plan are currently available – the Ijara and the Diminishing Musharaka.<sup>428</sup>

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<sup>427</sup> Home Purchase Plan via <<http://www.alrayanbank.co.uk/home-finance/home-purchase-plan/>> accessed: 11 April 2015

<sup>428</sup> Note that while the diagrams are based on the website of the former FSA, however, the usage of the diagrams is used as an example to show the Islamic finance mortgage arrangement in the UK. These diagrams are not shown in the current FCA Handbook, however, the mortgage remains the same at present.

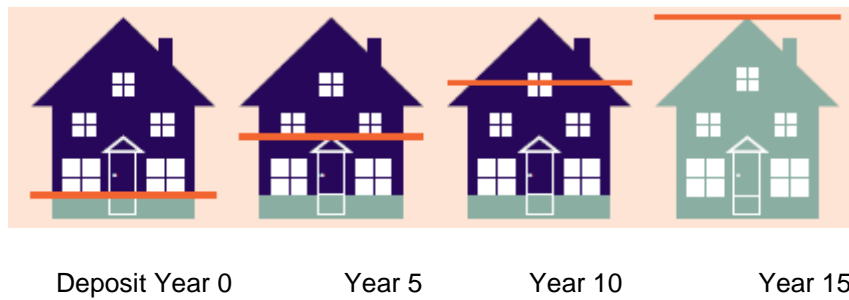


Figure 4: Ijara Home HPP (15 year term)

Source: former FSA

Firm's share – Purple  
Customer's share: Green  
Level of payment made: Orange

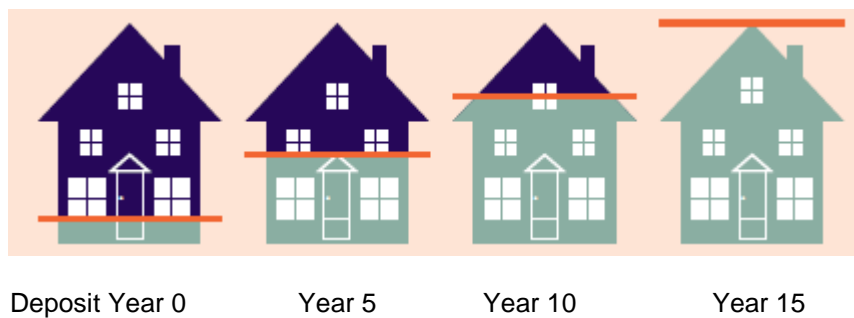


Figure 5 : Diminishing Musharaka HPP (15 year term)

Source: former FSA

Firm's share – Purple  
Customer's share: Green  
Level of payment made: Orange

The terms used to describe the Home Purchase Plan are different to those used in the Financial Conduct Authority (FCA) Handbook which leads to the lack of clarity in the regulation.<sup>429</sup> For instance, the illustration provided in the Handbook describes a different type Ijara which is called as Ijara Muntahiya Bitamlik (leasing leads to ownership) whereas, the term used in the Handbook to describe such arrangement is

<sup>429</sup> PERG14: 'Guidance on Home Reversion and Home Purchase Activities' via <https://www.handbook.fca.org.uk/handbook/> accessed; 1 September 2015

simple Ijara (simple leasing arrangement). Arguably, while these structures represent different practices; it is assumed that such practices may not differ in economic terms. It can, therefore, be deduced that the level-playing field in the regulation may give effect only in the legal context, although it may not necessarily affect the economic justification.

The following section highlights the fourth aspect in the existing regulation. It describes the features of Sharia supervision of an Islamic bank and analyses the regulator's treatment in respect of the level-playing field in the regulation.

#### **(d) SHARIA SUPERVISORY BOARD (SSB)**

*'Who guards the guardians?'<sup>430</sup>*

One of the distinctive features with regards to the governance of an Islamic bank and a conventional bank, is the establishment of a Sharia Supervisory Board (SSB). Sharia supervision is required for an Islamic bank to ensure that the activities conducted by an Islamic bank are in accordance with Sharia principles.

The table below shows the additional governance unit in an Islamic bank in comparison with a conventional bank. In practice, the additional governance unit varies from one jurisdiction to another. In the UK, there is no specific requirement for

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<sup>430</sup> The terms are derived from the famous political theory inquiry: '*Quis custodiet custodies*'. Richard A. Epstein in Patricia D.White, *Tax Law*, (1995), p.4

this additional unit. A typical Islamic bank, however, shall at least comprise of a Sharia board for governance and supervision.

FUNCTIONS	TYPICAL FINANCIAL INSTITUTIONS	ADDITIONS in ISLAMIC BANKS
Governance	Board of Directors	Sharia Board
Control	Internal Auditors	Internal Sharia Review Unit
	External Auditors	External Sharia Review Unit
Compliance	Regulatory and financial compliance officers, unit or department	Internal Sharia Compliance Unit

Source: Islamic Financial Services Board (IFSB)

An SSB, comprises a group of professionals and Sharia scholars in the area of *Fiqh-al-Muamalat* (Islamic commercial laws) that is able to provide expert opinions on Islamic financial services.<sup>431</sup> The Accounting and Auditing for Islamic Financial Institutions (AAOIFI) define an SSB as:-

An independent body of specialised jurists in *fiqh-al-muamalat* (Islamic commercial jurisprudence). However, the Sharia supervisory board may include a member other than those specialised in *fiqh-al-muamalat*, but who should be an expert in the field of Islamic financial institutions and with knowledge of *fiqh-al-muamalat*. The Sharia Supervisory Board is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution in order to ensure that they are in

<sup>431</sup> Islamic Financial Services Board (IFSB) 'Guiding Principles -10 on Sharia Governance Systems on Financial Institutions Offering Islamic Financial Services', (2009), p.22

compliance with Islamic Sharia Rules and Principles. The *fatwas*, and rulings of the Sharia Supervisory Board shall be binding on the Islamic financial institution.<sup>432</sup>

The SSB is part of the corporate governance structure of an Islamic bank and the operation of the SSB is either within the Islamic bank itself or through an external institution such as a central bank (often called the National Sharia Advisory Council) or a firm may appoint an independent Sharia consultant.<sup>433</sup> The SSB is responsible for issuing its verification and/or resolutions (often called a *fatwa*) on matters pertaining to issues in Islamic finance and matters relating to the Sharia-compliant financial products (including the design and development of the legal instruments).<sup>434</sup> It also includes the calculation of Zakah (alms giving), disposal of non-Sharia-compliant earnings and advice on the distribution of income or expenses among the bank's shareholders and investment account holders. These are the internal tasks of an SSB and the monitoring of an Islamic bank is often done on an *ex-ante* basis.<sup>435</sup> Facts have, however, shown that there is still lack of practice by Islamic banks in conducting ex-post Sharia compliance reviews. As stated by the Islamic Finance Services Board (IFSB),

“A particular aspect of Sharia compliance, which still appears to be generally lacking amongst IIFS is the conduct of external ex-post Sharia compliance reviews. In its survey, the IFSB found that only a small minority of the IIFS have external ex-post

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<sup>432</sup> Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) Governance Standard for Islamic financial Institutions No.1

<sup>433</sup> Hennie Van Greuning and Zamir Iqbal, *Risk Analysis for Islamic Banks*, (2008), p.188

<sup>434</sup> Ibid.,p.187

<sup>435</sup> Ibid.,p.189



Sharia compliance reviews, even then mostly carried out by their governing central banks.”<sup>436</sup>

The range of Islamic financial services could also be a factor in determining the need to have an SSB in an Islamic bank. An approach to determining the need to have an SSB is to establish the limits of Islamic financial offerings in a financial institution. If the range of Islamic financial products is very limited, the IFSB standards do not expect a conventional bank to have an in-house Sharia governance framework.<sup>437</sup> The IFSB made a clear differentiation between such organisations and fully-fledged Islamic banks or conventional banks that offer a broad range of Islamic finance products through ‘Islamic window’ operations, which requires a proper Sharia governance framework.<sup>438</sup> ‘Islamic window’ operations are given the flexibility to appoint an external Sharia advisory firm in their governance framework.<sup>439</sup>

As has been noted, the level-playing field in the UK’s financial services regulations represent the regulator’s neutrality towards all banking and financial services institutions. This means that the UK regulator did not intend to regulate the substance of an SSB’s activities. Therefore, the element of equality before the law (formal equality) does not show any preferential treatment by the UK regulator with regards to how the corporate governance and supervision of an Islamic bank should take place.

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<sup>436</sup> Islamic Financial Services Board (IFSB), ‘Guiding Principles on Corporate Governance For Institutions Offering Only Islamic Financial Services’, (December 2006) via <<http://www.ifsb.org/standard/ifs3.pdf>> accessed: 11 April 2015

<sup>437</sup> Ibid.

<sup>438</sup> Supra, Note. 431, p.8

<sup>439</sup> Ibid.

This has, therefore, raised certain regulatory conflicts with regards to the SSB in the conventional banking and financial services framework.

Before proceeding further, the following highlights the relation of a level-playing field in the regulation with regards to the corporate governance structure and supervision of Islamic banks.

With regards to the SSB functions, the regulator acknowledged the importance of the SSB's role in supervising the Islamic bank's products and transactions - particularly to ensure that the Sharia-compliant requirement has been met.<sup>440</sup> It encouraged the adoption of international regulatory standards by an Islamic bank – as this would convince them that Islamic banks adhere to the standards.<sup>441</sup> A level-playing field in the regulation, however, does not include any specific standard or requirement on the manner which an SSB should carry out its functions in an Islamic bank.<sup>442</sup>

It is expected, therefore, that no requirements were imposed on the composition of an SSB in the UK.<sup>443</sup> The establishment of an SSB depends on whether the bank is a fully fledged Islamic bank or a conventional bank that operates 'Islamic windows' or a financial institution handling Islamic finance transactions on an ad-hoc basis.<sup>444</sup> Notably, with regards to the composition of an SSB, the number of the board members

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<sup>440</sup> Ibid.

<sup>441</sup> Supra, Note. 411, p.16

<sup>442</sup> Ibid., p.13

<sup>443</sup> Ibid., p.16

<sup>444</sup> Ibid., p.8

varies from one regulatory authority to another. According to AAOIFI standards, the composition of an SSB should consist of at least three members.<sup>445</sup> However, some countries like Malaysia<sup>446</sup> and Iran<sup>447</sup> require an Islamic bank to have a minimum of five members sitting in an SSB.

In the level-playing field regulations, the regulator has to be informed of the exact role of the SSB's members in an Islamic bank - whether the member is playing an executive role or an advisory role; and how the SSB's function would affect the operation of the firm.<sup>448</sup> This is thought to be sufficient guidance for the regulator to impose suitable requirements that must be fulfilled by the SSB members.

For instance, if the SSB member is to play an executive role, each of the Islamic banks is required to apply for each member to be an 'approved person' under the FCA/PRA High Level Standards - called as the 'Fit and Proper Test for Approved Persons.'<sup>449</sup> One of the essential criteria in the 'approved person' rule is to prove the person's competency and capability to carry out his or her function. In order to prove that criterion, the relevant training and competency requirements (or as termed by the regulator 'relevant experience') must be fulfilled by the SSB member.<sup>450</sup>

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<sup>445</sup> Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) Governance Standard for Islamic financial Institutions No.1

<sup>446</sup> Global Islamic Finance Report 2012

<sup>447</sup> Strategic Plan for an Islamic Banking Industry in Pakistan via  
<<http://www.sbp.org.pk/departments/pdf/StrategicPlanPDF/>> accessed: September 2013

<sup>448</sup> Supra, Note. 411, p.16

<sup>449</sup> Ibid.

<sup>450</sup> FCA and PRA Handbook, FIT 2.2.1

The regulator regards an executive role as being an active role for the SSB member in the Islamic bank's operations, thus resembling the role of an executive director rather than a non-executive director.<sup>451</sup> An executive director is a person who has the capacity to exercise significant influence by way of his involvement in taking decisions for that firm.<sup>452</sup> Thus, this scope of duty requires an SSB member to be actively involved in the decision making of an Islamic bank.

In this respect, applying for the authorisation as an executive role could be a challenge for an Islamic bank. This is because, an Islamic bank needs to fulfil the requirement of 'whether the person has adequate time to perform the controlled function and meet the responsibilities associated with that function.'<sup>453</sup> In reality, a Sharia scholar often performs his duties on multiple Sharia boards.<sup>454</sup> For instance, a report has shown that the top 100 Sharia scholars are sitting on 953 boards and represent 83.52% of the global total board positions. This has, therefore, raised some concern relating to the potential for conflicts of interest among Sharia scholars.<sup>455</sup>

In the existing conventional regulatory framework, the issue remains as to whether the position of a Sharia member is as an employee of an Islamic bank. For instance, if the position of an SSB member is as an employee of the firm, the provisions of the Companies Act 2006 governing the directorship role would apply - as a bank is

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<sup>451</sup> Supra, Note. 411, p. 13

<sup>452</sup> FCA and PRA Handbook, SUP 10.6.5

<sup>453</sup> FCA and PRA Handbook, FIT 2.2.1 (3)

<sup>454</sup> Murat Ünal, 'The Small World of Islamic Finance: Sharia Scholars and Governance- A Network Analytic Perspective v.6.0', Report: *Funds@Work* (2011) via <<http://www.funds-at-work.com/>> accessed: 1 September 2012

<sup>455</sup> Ibid.

typically a company. As such, the directors' duties requirement is applicable to the SSB member. For example, based on the Companies Act 2006 regulation, one of the duties is to avoid conflict of interest. Hence, an SSB member who is sitting on multiple boards is constrained by such regulation.<sup>456</sup>

The regulatory accommodation for an SSB member to apply for an executive director role raises an issue when such a role is given through a service contract. If the Sharia board member is appointed by virtue of a service contract, he is then regarded as an employee of the firm.<sup>457</sup> However, an essential condition stipulated by AAOIFI on the governance of an Islamic bank is that a Sharia scholar cannot be an employee of the firm.<sup>458</sup>

With respect to the advisory role, an Islamic bank need not apply for each member to be an approved person.<sup>459</sup> What is required by the regulator is that the Islamic bank should be able to show that the role and responsibilities of their SSB member is merely advisory and does not interfere with the management of the firm.<sup>460</sup> Thus far, the regulator has reported that most Islamic banks apply for their SSB members to be appointed in an advisory role and they have successfully fulfilled those requirements.

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<sup>456</sup> Section 175 of the Companies Act 2006

<sup>457</sup> 'Directors as Employees' via <<http://www.companylawclub.co.uk/>> accessed: 11 April 2015

<sup>458</sup> Accounting and Auditing Organisation for Islamic Financial Institutions Governance Standard for Islamic Financial Institutions No.5

<sup>459</sup> Andrew Henderson, 'Islamic Financial Institutions' in Craig R. Nethercott and David M. Eisenberg, *Islamic Finance: Law and Practice* (2012), p.63

<sup>460</sup> Supra, Note. 411, p. 13

<sup>461</sup> Ibid.

The question of conflict of interest by a Sharia scholar, however, is difficult to prove. In fact, there is no empirical evidence to show that conflict of interest has happened apart from the general assumption provided in the report mentioned earlier. Nevertheless, the possibility of conflict of interest from an SSB should not be ignored by the regulator. Apart from the report above stating that a Sharia scholar sits on multiple boards of Islamic banks worldwide, the Islamic Financial Services Board (IFSB) indicates that there could be a potential conflict of interest within the SSB members. The provision of the Governance states that an Islamic bank should ensure that,

“the Sharia board is more focused, with more time spent on each assignment and *conflicts of interest adequately managed*,” (emphasis added) <sup>462</sup>

The SSB, which is regarded as the backbone of an Islamic bank is the group of people that decides the path an Islamic bank should take. Their approval is significant for an Islamic bank and could determine the future of the bank, especially on the Sharia-compliant aspect of a particular transaction. The fact that conventional regulation treats all banks and financial services institutions on a level-playing field, the absence of SSB regulation makes them the ‘unofficial’ governors of an Islamic bank.

The next section examines and analyses some challenges that arguably have created regulatory uncertainties from the ‘Fit and Proper Test for Approved Persons’ rule arising from the conventional regulatory framework.

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<sup>462</sup> Supra, Note. 431, p.9

**(i) ‘Competent’ requirement**

The IFSB requires the Board of Directors and senior management of an Islamic bank to comply with certain minimum criteria primarily to create public’s confidence – that the Islamic bank they are dealing with is competent, honest, financially sound and will treat them fairly.<sup>463</sup>

By referring to the IFSB standards, the competency requirement of an SSB member is massive. In addition to the requirement of being an expert in Fiqh-al-Muamalat, the IFSB imposed a minimum standard for an SSB member - the understanding of finance in general, strong skills in the principles of Islamic law (Usul al-Fiqh), good knowledge of written Arabic is expected and it is highly recommended for an SSB member to be able to converse in English.<sup>464</sup> Thus, in principle, apart from having an expertise in Fiqh-al-Muamalat, the competency requirement for an SSB member requires an understanding of Islamic finance and law, language and conventional banking practices.<sup>465</sup> In Malaysia, the standard imposed by the country is that a Sharia advisor is required to have at least a Bachelors Degree in Sharia or Islamic Transactions or Islamic Commercial Law (Fiqh-al-Muamalat).<sup>466</sup>

The UK’s regulator did not impose any specific requirements in regard to the competency of an SSB member; neither is there a defined term for the competency requirement for an ‘approved person’ in the FCA/PRA Handbook. The word

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<sup>463</sup> Ibid., p.11

<sup>464</sup> Ibid., APPENDIX 4

<sup>465</sup> Ibid.

<sup>466</sup> Ibid.

‘competent’ as defined in the Oxford Dictionary is, however, ‘having the necessary ability, knowledge, or skill to do something successfully.’<sup>467</sup>

The distinctive features of an Islamic bank’s corporate governance are acknowledged by the regulator, however, they did not wish to provide a set of criteria as a benchmark for the competency requirement of a Sharia scholar - mainly for the reason that they are not a religious regulator.<sup>468</sup> This essentially means that in the level-playing field regulation, the UK’s regulator permits anyone to regard themselves as a Sharia scholar. Hence their role is assessed based on the conventional corporate governance criteria. As such, a person who is appointed as a Sharia scholar is assessed by the ‘approved person’ rules. It was, however, admitted by the then FSA that most of the Sharia scholars would not meet the criteria for an ‘approved person’.

<sup>469</sup>

It can, therefore be argued that the absence of competency requirements for a Sharia scholar in the conventional regulatory framework ultimately lead to regulatory uncertainties at the substantive level (institutional aspect). Additionally, it can be argued that the absence of the requirement could possibly create a lack of confidence in an Islamic bank’s corporate governance. (Note that in the previous chapter, it is asserted that a level-playing field is comprised of the element of substantive equality. The substantive equality is divided into two— transactional level and institutional level.)

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<sup>467</sup> ‘Competent’ meaning via <<http://oxforddictionaries.com/>> accessed: November 2013

<sup>468</sup> Supra, Note. 273, p. 13

<sup>469</sup> Ibid.



It is therefore suggested that the competency requirements for a Sharia scholar in an Islamic bank should be based on the IFSB standards.

We now turn to the next criteria of the ‘approved person’ rule based on the existing regulatory framework.

## **(ii) ‘Relevant experience’**

The term relevant experience is not defined anywhere in the legislation, therefore, what constitutes an ‘experienced’ person is a matter of interpretation. In the existing regulation, there is no express indication on the number of years in the profession that one needs to have in order to regard that the condition of ‘relevant experience’ as being met. Thus, the question of the number of years in the industry is not a factor in considering whether or not a candidate is an ‘experienced’ person. In practice, the burden of proof is upon the Islamic bank to show to the regulator that the SSB’s member possesses the relevant experience.<sup>470</sup> Based on Al Rayan Bank’s SSB member’s profile, it is indicated that the SSB members generally acquire ‘relevant experience’ based on their participation in other SSBs or have had a strong educational background that relates to the field of Islamic finance.<sup>471</sup>

The open-ended interpretation for ‘relevant experience’, arguably, creates regulatory uncertainty at the substantive level (institutional). The UK’s regulator leaves the matter to Islamic banks to decide what constitutes ‘relevant experience’ for an SSB member.

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<sup>470</sup> Ibid.

<sup>471</sup> Al Rayan Bank, The Sharia Supervisory Committee via <<http://www.alrayanbank.co.uk/useful-info-tools/islamic-finance/>> accessed: 11 April 2015

Although one may argue that 'relevant experience' is a generic term that every institution should be able to decide based on their preferences, nevertheless, this may not be the case for an SSB. This is because the position of an SSB is regarded as crucial in an Islamic banking institution due to its function as the 'governor' of the bank.

The case of *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd & Ors*<sup>472</sup> proved that Islamic banks can be exposed to regulatory risk when the Sharia compliance of a product is questioned. In this case, one of the defendants' arguments was that the agreement entered into comprised an element of Riba, which essentially has violated the principles of Sharia. The reported case has therefore raised questions on the ability of the regulator to monitor firms and the products they are selling. While the aforementioned case also comprised other issues, in particular the governing law of the contract; nevertheless, the issue of the Sharia-compliant aspect of the contract should not be taken lightly. The impact of the issue raised could lead to the argument that an Islamic bank has failed to act in a prudent manner and misrepresented the products they are selling to the consumer. This essentially causes a lack of confidence in the market and reduces the equal opportunity of Islamic banks to compete as the quality of the products approved by the SSB is questionable when disputes arise. Essentially, the competency of the SSB is also disputable.

Arising from the absence of an SSB competency requirement, it can be argued that the level-playing field in the regulatory framework is in conflict with the FCA's approach to regulation such as: to protect consumers; analyse risks and the impact on the

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<sup>472</sup> (2004) 4 All ER 1072

market; ensure that firms uphold market integrity; the firms it regulates are financially sound and urging all the firms to act in a prudent manner to avoid misrepresentation.<sup>473</sup>

As stated earlier, the difference between the corporate governance of Islamic banks and conventional banks is the existence of an SSB. Thus, having a 'Fit and Proper' SSB is crucial, because an Islamic bank's operation and reputation relies much on the strength and competencies of the SSB. Leaving an Islamic bank to freely decide without a general guideline by the regulator could create a degree of weakness in the regulation. Additionally, it could also suggest that the regulator does not fully acknowledge the difference between Islamic banks and conventional banks. Arguably, having a benchmark could raise the SSB of an Islamic bank in the UK to a better standard. It could also help the Islamic bank to have a 'Fit and Proper' SSB. Moreover, having a certain benchmark for an SSB will not cause the UK's regulator to be regarded as a 'religious regulator'.

The possible solution to a lack of regulation is to consider creating a 'competency' requirement for an SSB in the conventional regulatory framework. In principle, an SSB should comprise various experts on one board. As stated in the IFSB Guidelines, there must be a combination of experts in the areas of commerce or finance in retail banking, Takaful (Islamic insurance) undertaking or capital market products in an SSB. The benchmark for a 'competency' requirement for the SSB would not only strengthen the quality of the corporate governance framework of an Islamic bank, but could also minimise the governance risk.

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<sup>473</sup> Financial Conduct Authority, 'Our approach to regulation' via <<http://www.fca.org.uk/about/what/regulating>> accessed: 11 April 2015

We now turn to the next section which analyses the extent to which the English courts are willing to consider the Sharia compliance issues in disputed Islamic financial contracts and to what extent the judgment reflects the level-playing field in the regulation.

#### **(e) ISLAMIC FINANCE CASES BEFORE THE ENGLISH COURTS**

Thus far, only a few Islamic finance cases have been heard before the English courts. To date, it can be argued that Islamic financial disputes have been treated equally before the law and the doctrine of formal equality has been well implemented by the English courts. Islamic finance cases were given equal opportunity to be heard in the UK's judicial proceedings. In spite of this, it is argued that the element of substantive equality is limited to a certain extent. Two cases are provided to highlight this point.

The case of *The Islamic Investment Company of the Gulf (Bahamas) Ltd v. Symphony Gems N.V. and others*,<sup>474</sup> was the first Islamic finance case heard and decided by the English courts. In this case, the claimant (The Islamic Investment Company of the Gulf (Bahamas) (Ltd) (hereinafter IICG) entered into a Murabaha financing agreement with the first defendant (Symphony Gems N.V) (hereinafter Symphony Gems). The first defendant requested IICG to purchase a large quantity of precious gems and stones from the Hong Kong-based supplier, Precious (HK) Ltd. for USD 15,000,000 and then to sell it to Symphony Gems by way of instalments (as mutually agreed in the agreement) for USD 15,834,900.00. The Murahaba financing agreement

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<sup>474</sup> [2002] All ER (D) 171

contained an English law of choice and jurisdiction clause. As the supplier of the diamonds was not able to supply the requested gems, no delivery of diamonds was made to Symphony Gems. As such, Symphony Gems refused to pay the instalments. As such, IICG applied for summary judgment before the English Queen's Bench Division against Symphony Gems for the recovery of the sums owed to them.

The question of the Sharia-compliant aspect of the agreement was raised by the first defendant in this case. Before proceeding further, in principle, Murabaha consists of two promises: (i) a promise by the customer to purchase the goods and (ii) a promise by the bank to sell the goods. The transaction is concluded when the goods are placed in the possession of the customer. Moreover, before the goods are placed in the possession of the customer, risks associated with the goods are with the bank.<sup>475</sup> It was argued that the Murabaha agreement was in reality a purchase and sale agreement and that IICG's claim to recover the sale price should fail because IICG delivered no goods to Symphony Gems. IICG, however, has its safety clause by provisions in the Murabaha agreement which state that:

"The relevant instalments of the Sale Price in respect of each Purchase Agreement shall be payable by the Purchaser to the Seller on the due dates thereof, whether or not: (a) any property in the Supplies has passed to the Purchaser under the relevant Purchase Agreement and/or to the Seller under the relevant Supply contract..."<sup>476</sup>

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<sup>475</sup> Hakimah Yaacob, 'A Critical Appraisal of International Islamic Finance Cases, and the Way Forward', (2011), p.5

<sup>476</sup> Clause 4.4. of the Murabaha Agreement in *The Islamic Investment Company of the Gulf (Bahamas) Ltd v. Symphony Gems N.V. and others* [2002] All ER (D) 171

And,

“In particular, the seller shall have no liability in respect of loss, damage or deterioration of the supplies in transit...”<sup>477</sup>

The provision above is, however, against the principle of a Murabaha transaction as the risks should be borne by the seller (in this case it is upon IICG) and the risks in relation to the goods should be borne upon the seller before the goods were transferred to the buyer (Symphony Gems). The court in this case called two expert witnesses to clarify the Sharia-compliant aspect of the agreement and it was confirmed that the agreement was not Sharia compliant. Nevertheless, the Court rejected all the defences by the defendant and held that the defendant was liable to pay the debt owed amounting to USD 10,060,354.28. The *ratio decidendi*<sup>478</sup> by the Court was that delivery is not a prerequisite for payment and the risks borne by the bank were properly insured.

This case has shown that while the court has testified that the Murabaha agreement was not Sharia compliant, nevertheless, the Court was reluctant to adopt those views. The Court has applied the English rules interpretation in deciding the case and the question of the Sharia-compliant aspect of the case was disregarded. It can be argued that in this aspect, the application of substantive equality at the transactional level was ignored. The case would have been viewed differently should the Court have taken into account the opinions of the expert witnesses. However, since the provision of the

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<sup>477</sup> Clause 5.7 of the Murabaha Agreement in *The Islamic Investment Company of the Gulf (Bahamas) Ltd v. Symphony Gems N.V. and others* [2002] All ER (D) 171

<sup>478</sup> *Ratio Decidendi* (Latin) = reason for the decision

Murabaha agreement expressly stated the liability of both parties and IICG was protected by the governing clause, the Court has rightly applied the English law of contract.

The case of *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd & Ors*, *Shamil Bank* ('the Bank')<sup>479</sup> is another example where the issue of substantive equality can be examined.

In this case, the Bank acted as a claimant/respondent and Beximco Pharmaceuticals ('Beximco') acted as a defendant/appellant. This case was brought by the claimant on the ground that the defendant had failed to settle the remaining sum of the loan entered into in a Murabaha and Ijara financing agreement with the Bank. On appeal, the main issue was related to the governing law of the agreement. That clause stated that:-

"Subject to the principles of the Glorious Sharia, this Agreement shall be governed by and construed in accordance with the laws of England."<sup>480</sup>

The disputed issue was whether the contract should be governed by English law and Sharia law or English law alone. The defendants' principal argument was that the agreement entered into comprised an element of Riba, which essentially violated the principles of Sharia. It was further argued by the defendants' counsel that the 'doctrine of incorporation' should be applied in this case when interpreting the governing law of

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<sup>479</sup> (2004) 4 All ER 1072

<sup>480</sup> Ibid.

the agreement whereby ‘the rights of the parties to choose foreign law as the choice of law to govern their contract and at the same time they are free to incorporate into their contract terms of some of the provisions of the foreign law.’ Hence, it was argued by the defendants that the parties had chosen English law as their governing law and the parties had incorporated the terms of Sharia law into their contract, which should have a binding effect. The agreement should, therefore, be held null and void.

The defendant’s counsel suggested that the way of viewing the ambit of Sharia and English law in a contract is that ‘the clause should be read as incorporating simply those specific rules of Sharia which relate to interest and to the nature of the Murabaha and Ijara contracts, thus qualifying the choice of English law as the governing law only to that extent.’ While the argument seems to be a valid argument that represents the application of substantive equality, the judge in this case viewed that the relevance of Sharia principles could not be relied upon substantively. The judge therefore upheld the decision of the High Court, which gave favour to the claimant. The judge, Potter LJ, noted that:-

“The general reference to principles of Sharia in this case affords no reference to, or identification of, those aspects of Sharia law which are intended to be incorporated into the contract, let alone the terms in which they are framed...Thus the reference to the “principles of ... Sharia” stand unqualified as a reference to the body of Sharia law generally. As such, they are inevitably repugnant to the choice of English law as the law of the contract and render the clause self-contradictory and therefore meaningless.”



The *ratio decidendi*<sup>481</sup> of the case was based on Article 3 (1) of the Rome Convention on the Law Applicable to Contractual Obligations 1980 (Rome Convention 1980), which has the force of law in the UK. The provision stated that the law 'shall be governed by the law chosen by the parties' and Article 1 of the Rome Convention 1980 states that:

"The rules of this Convention shall apply to contractual obligations in any situation involving a choice between the laws of different countries."<sup>482</sup>

Therefore, it was argued that Sharia law is not a law of a country and there is an absence of provision for the choice or application of a non-national system of law such as Sharia law. Furthermore, the judge cited an example of The Hague Rules or the French Civil Code where,

"the doctrine of incorporation can only sensibly operate where the parties have by the terms of their contract sufficiently identified specific 'black letter' provisions of a foreign law or an international code as terms of the contract."<sup>483</sup>

By the principle above, the judge argued that 'English law is applied as the governing law to a contract into which the foreign rules have been incorporated.'<sup>484</sup> In this regard, while the court is ready to adopt foreign rules, the basis of judgment was based on the principles of the law of contract.

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<sup>481</sup> Supra, Note. 478

<sup>482</sup> Rome Convention on the Law Applicable to Contractual Obligations 1980

<sup>483</sup> (2004) 4 All ER 1072

<sup>484</sup> Ibid.

It was held that the matter of the Sharia compliance of the agreement was not a matter of concern by the defendants upon the conclusion of the agreement or before the proceedings. Morrison J argued that:-

“So far as the bank was concerned, that is likely to have been sufficient for its own regulatory purposes and there is no suggestion that the defendants were in any way concerned about the principles Sharia law either at the time the agreement was made or at any time before the proceedings were started.”

Additionally, the Court was also not prepared to judge on the Sharia aspect of the contract as the Sharia rules were un-codified. Hence, the matter should be left to the bank's religious board to monitor the Sharia compliance of the contract in the international banking context.

Based on the above *ratio decidendi*, the judgment was made in favour of the Bank. While the fact that the contract is referred to as purely a contract law, arguably, the English courts should provide more accommodation on the issue of the Sharia compliance of a contract. Authors<sup>485</sup> have argued that the English courts were quite reluctant to discuss the Sharia-compliant aspect of Islamic financial transactions for several reasons including the secular nature of the English courts, as well as the limitation stated in the Rome Convention 1980. Moreover, the court's reluctance was also due to the fact that Islamic financial contracts are viewed simply as the law of contract.

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<sup>485</sup> Jonathan Ercanbrack, "The Regulation of Islamic Finance in the United Kingdom", (2011), Ecc. L.J. 2011, 13(1), 69-77, Abdul Karim Aldhoni, *The Legal and Regulatory Aspects of Islamic Banking*, (2010), Adnan Trakic and Hanifah Haydar Ali Tajudin (eds), *Islamic Banking & Finance: Principles, Instruments and Operations*, (2012)

It can, however, be argued that in almost all of the reported cases<sup>486</sup> thus far; the question of the Sharia compliance of a contract arises when the defendants were in default payment for the sole interest of the debtors for the purpose of loan financing rather than having the *bona fide* intention of having a Sharia-compliant transaction. The English courts, therefore, treated Islamic financing agreements in a similar way to conventional financing agreements. Thus, the argument on the Sharia-compliant aspect of a contract could not be the strongest point in a trial, but just a mere reference for the English courts. For example, in the case of *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd & Ors*, Potter LJ stated:

“the factual assertions of the defendants themselves, which demonstrate that their sole interest was to obtain advances of funds to be used as working capital and that they were indifferent to the form of the agreements required by the Bank or the impact of Sharia law upon their validity.”

In spite of the above argument, it can further be argued that the willingness of the English court to call two expert witnesses in Beximco’s case and the Symphony Gems’ case to clarify Sharia principles shows that the English court has made the attempt to apply the substantive equality when the court was ready to hear what Sharia entails in order to assist the judges to deliver their judgment.

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<sup>486</sup> The Investment Dar Company KSCC v. Blom Developments Bank SAL (2009) EWHC 3545 (Ch.), Islamic Investment Company of the Gulf v. Symphony Gems NV & Others [2001] Folio 1226, Shamil Bank of Bahrain v. Beximco Pharmaceuticals Ltd & Ors (2004) 4 All ER 1072.

As argued earlier, in the case where the question of the Sharia-compliant aspect is regarded as a crucial issue to be tried – resorting to a mini-trial attended by Islamic financial experts could be a better approach to promote greater substantial equality for Islamic financial contracts in dispute. It can also be suggested that when the issue of Sharia compliance is a serious issue to be tried, the alternative of having a mini trial comprised of selected Islamic finance experts is indeed a good resort for discussing the Sharia-compliant aspect of a transaction - especially when the Bank's SSB could not solve a dispute. For example, in some countries such as Malaysia and Pakistan where substantive Sharia issues have failed to be solved at the institutional level, the government has established a National Sharia Advisory Council that can overrule the decision made at the subordinate level. In Malaysia, for example; the High Court of Kuala Lumpur has established a specific court to hear Islamic finance cases known as the Muamalat (Islamic Transactions) Bench within the Commercial Division. The judge of this court is required to have expertise in the area of Islamic commercial contracts as well as common law.

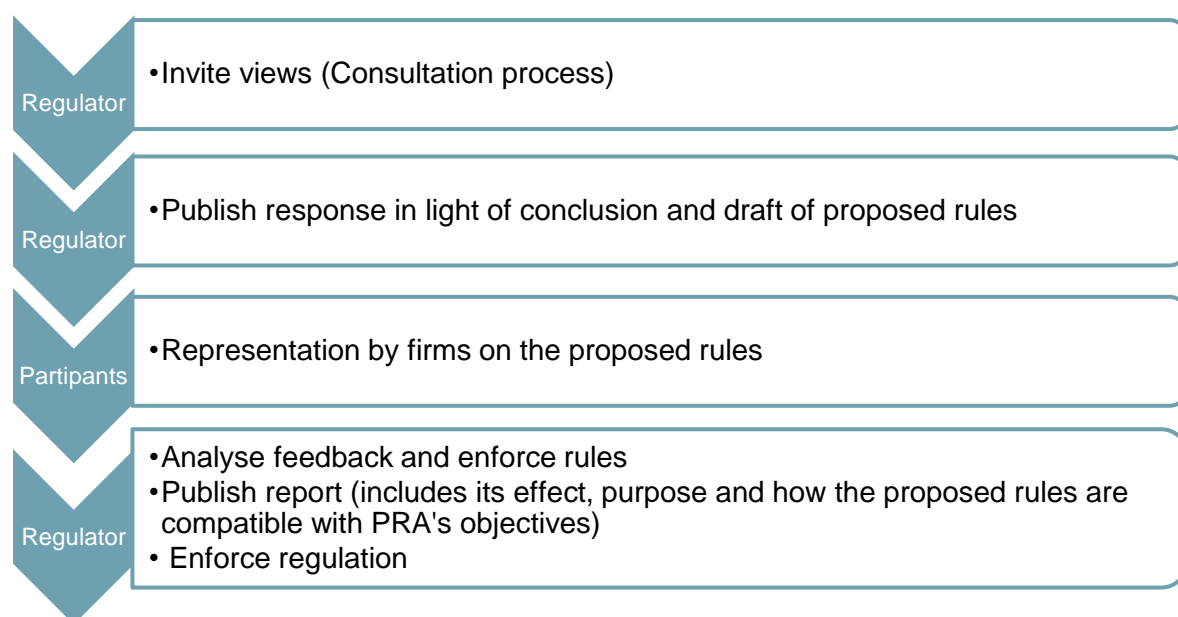
The level-playing field in the UK judicial system clearly shows the neutral and secular nature of the English courts. The evidence above demonstrates that the secular nature of the courts means that the Sharia-compliant issues in an Islamic financial contract did not influence the court's judgement; instead, common law contract principles were implemented. Nevertheless, it can be argued that the English judicial system does not fully disregard the Sharia-compliant issue. With regards to the question of a level-playing field, the lack of interest by the English courts does not

mean that there is no fairness in the regulatory treatment of Islamic finance. Other factors in the cases were considered to be more important than the issue of Sharia compliance although the Sharia-compliance aspects of the contracts were considered and expert witnesses were called to clarify the question of Sharia. An improved level-playing field can be achieved, however, if the UK's regulators were to establish a national Sharia advisory council to assist with Islamic finance issues. Nevertheless, one may argue that this suggestion may not be fully realised if there is a lack of lobbying efforts by the Islamic financial market players.

#### **(f) THE REGULATORY DECISION MAKING PROCESS**

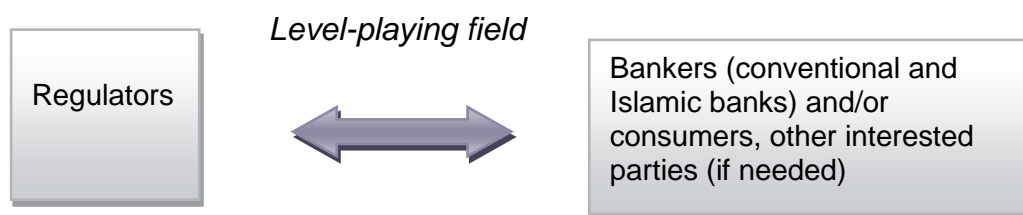
The consultation process is not defined anywhere in the Financial Services Markets Act 2000, neither is it defined in any legislation. Nevertheless, the Prudential Regulatory Authority's Approach to Consultation is helpful to describe how a consultation process is carried out. The blueprint describes the consultation process as a stage where the regulator engages with the practitioners (authorised persons from the regulated firms [bankers]), consumers (if needed) and other interested parties (if needed) to gather and discuss the arising issues. The regulator will seek the views of participants as to how the proposed means of achieving the regulator's objectives will affect their particular business. The regulator, according to circumstances, will need to publish its conclusions in light of the consultation and publish the draft of the proposed rules for the firms to make representations on the proposal. The feedback from the regulatory proposal will then be analysed before any decision is taken to

make it an enforceable regulation.<sup>487</sup> The above description of the process can be simplified in the following diagram:



Now that the general picture of consultation and regulatory decision-making processes have been explained, it is worth looking at how the concept of a level-playing field may be interpreted in the process as part of the regulatory decision making. Thus far, there is no published work that describes exactly how the consultation process is carried out and to what extent; the concept of a level-playing field can be assumed to exist during the process. Based on the interviews held between among practitioners in the banking industry who typically get involved in the regulatory decision-making process, the general picture of the process can be demonstrated as follows:

<sup>487</sup> The Prudential Regulations Authorities' Approach to Consultation (27 December 2012) via <<http://www.bankofengland.co.uk/>> accessed: 20 March 2015

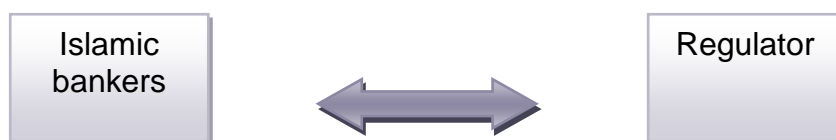


(i. information exchange ii. feedback iii. outcome iv. regulatory proposal)

Diagram 1

Source: Author's own

The diagram above represents the general picture of the consultation process between the regulator and the bankers. Most of the time, a regulatory proposal is directed to all banking services, both the conventional and Islamic banks. This process implies the application of formal equality. It can be argued, however, that a regulatory proposal, which is often designed to serve the issues faced by the banking institutions as a whole, may not necessarily serve the minority. In this regard, Islamic banks are a minority. The outcome of the formal equality in the first stage of regulatory decision making, therefore, may not necessarily be substantially equal. As such, once the regulation is imposed on all the banking institutions, it is left to the Islamic bankers to raise those issues that affect the functioning of the Islamic banking sector arising from the regulatory accommodation. The illustration can be interpreted in the following diagram:



(i. information exchange ii. feedback iii. outcome iv. regulatory proposal)

Diagram 2

Source: Author's own

The above diagram shows the circumstances where Islamic bankers pose their regulatory concerns based on the existing regulation to the regulators. It is to be noted that this process only happens if the Islamic bankers wish to forward their concerns. Nevertheless, from this process, it can be inferred that substantive equality exists when the regulator attends to the issues raised by the Islamic banks and consider making regulatory amendments.

Relying on both the regulatory decision-making processes (diagram 1 and 2) above, the positioning of the subjects (conventional and Islamic banks) is reflected as follows:

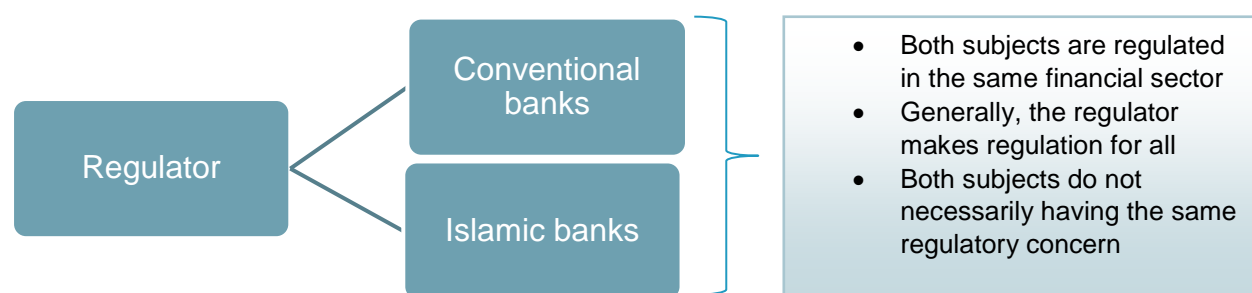


Diagram 3

Source: Author's own

\*The above diagram shows that the positioning of the conventional and Islamic banks is separated.<sup>488</sup>

In general, the regulatory proposal made by the regulator is to be imposed on all banking institutions.<sup>489</sup> Based on the regulator's practice during the regulatory

<sup>488</sup> The process was discussed on individual interviews as well as informal conversations held between Islamic banking practitioners who hold different posts, consisting of bankers and consultants.

<sup>489</sup> Ibid.



decision-making process at the first stage, the practice implies that it is not necessary for the regulator to consider the effect of the proposed regulation on Islamic banks. For instance, this can be seen in the existing regulatory framework where Islamic banks are required to follow the conventional regulatory framework. Hence, a separate regulatory decision-making process will be conducted, only if the Islamic banks are affected by the existing, conventional regulatory framework.

In light of achieving the PRA's objective, it can be argued that the standard practice by the regulator raises a level-playing field concern where the regulator makes regulatory decisions based on the majority of banking institutions without necessarily considering Islamic banks at the initial stage. In other words, the standard practice appears to be somewhat contradictory to the original purpose of making regulations, which are supposedly targeting banking institutions as a whole. There are, however, two possible rationales arising from the standard practice. Firstly, there are only a few Islamic banks in the UK as opposed to their conventional counterparts. It is, therefore not unusual that regulatory decision making is often made for the majority of the market players as they largely influence the stability of the financial system. Arguably, it is also unfair to assume that the lack of regulatory accommodation for the Islamic banking sector would not affect the health of the financial system in the UK. Secondly, it has been argued that understanding the inherent risks faced by Islamic banks is something of a challenge for the regulator to take into account unless they are raised by the Islamic bankers themselves.<sup>490</sup>

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<sup>490</sup> Ibid. See, the regulatory process before the making of a new regulation in HM Treasury, '2010-2015 Government Policy: Bank Regulation', (May 2015) via <<https://www.gov.uk/government/>> accessed: 28 August 2015. The background of the making of a new regulation was carried out through consultation process and the responses to the consultation are used to develop the Banking Reform Bill.

Following from the above discussion, the next issue is to what extent the regulatory decision-making process affects the element of fair opportunity to compete? In addition, how does the process impact the concept of a level-playing field? Based on Diagrams 1 and 2, it can be suggested that there are two perspectives on interpreting the element of fair opportunity to compete. Firstly, Diagram 1 shows that the element exists when a regulatory proposal is made to all banking institutions at one time - regardless of whether a regulatory proposal affects the performance of Islamic banks. This means that all banking institutions are competing fairly based on the same regulation. Nevertheless, one may also argue that the effect of some regulatory accommodations could affect the performance of Islamic banks; therefore, the element of fair opportunity to compete does not exist. One may also agree, however, that there is the element of fair opportunity to compete when Islamic banks are given the appropriate platform to raise their regulatory concerns (Diagram 2).

In sum, the notion of a level-playing field in the regulatory decision-making process, at the first instance, is not really obvious in the case of Islamic banks. By looking at both perspectives, however, a level-playing field can be said to exist when the regulatory decision-making process involves all banking institutions in the UK. Moreover, the existing practice does deliver substantive equality when a separate consultation process is conducted to help Islamic banks address their regulatory concern. Ultimately, the element of fair opportunity to compete could also be assumed to be present. The existing practice affirms the view that a level-playing field does exist in the UK's regulatory decision-making process for Islamic banks.

## **(g) SHARIA-COMPLIANT LIQUID ASSETS**

This section examines the current regulatory proposal for Sharia-compliant liquid assets regulations for Islamic banks by the Prudential Regulatory Authority (PRA) and investigates whether there are problems relating to a level-playing field in the regulation and whether the regulators are able to create a level-playing field in the regulation.

An appropriate regulatory framework to support liquidity management is crucial to maintain a sustainable and healthy financial system. The global financial crises have shown that the banking system came under severe liquidity stress hence prudential regulators have been focusing on providing an appropriate regulatory framework for liquidity management of banks.<sup>491</sup> In March 2014, The Prudential Regulation Authority set out regulatory proposals on Sharia-compliant liquid assets regulations for Islamic banks in the UK. This is because there have been calls for change since the existing regulations do not give Islamic banks enough options to sufficiently manage their liquidity.

Liquidity refers to 'a measure of the ability and ease with which assets can be converted to cash.'<sup>492</sup> Liquid assets are those that can be converted to cash quickly if needed to meet financial obligations; examples of liquid assets generally include cash, central bank reserves, and government debt. To remain viable, a financial institution must have enough liquid assets to meet its near-term obligations, such as withdrawals

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<sup>491</sup> BCBS Principles for Sound Liquidity Risk Management and Supervision via <http://www.bis.org/publ/bcbs144.pdf> accessed: 10 March 2015

<sup>492</sup> Liquidity and Capital via [http://www.federalreserve.gov/faqs/cat\\_21427.htm](http://www.federalreserve.gov/faqs/cat_21427.htm) accessed: 10 March 2015

by depositors.<sup>493</sup> The Basel Committee on Banking Supervision (BCBS) defined liquidity as ‘the ability of a bank to fund increases in assets and meet obligations as they become due, without incurring unacceptable losses.’<sup>494</sup> Liquidity is an essential element in the macro economy and this element exposes banks to liquidity risk, therefore, establishing a comprehensive regulatory framework to minimise the exposure to liquidity risk in banking is crucial.

The existing regulation in the UK’s regulatory framework shows that there are three problems which are inter-related when implementing a level-playing field in the regulation. These are: (i) eligibility of the asset (ii) concentration risk and (iii) available options for liquid assets. The first problem is where the existing regulation shows that there is currently only one asset that meets the eligibility criteria for inclusion in an Islamic bank’s liquid assets buffer.<sup>495</sup> In the existing regulation, the eligibility criteria for inclusion in a firm’s liquid assets buffer means that all financial institutions’ assets are limited to only:

- (i) *high quality debt securities* issued by a *government or central bank*;
- (ii) *securities issued by a designated multilateral development bank*;
- (iii) reserves in the form of sight deposits with a central bank of the kind specified in BIPRU 12.7.5R and BIPRU 12.7.6R; and

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<sup>493</sup> Ibid.

<sup>494</sup> BCBS, via <<http://www.bis.org/index.htm>> accessed: 10 March 2015

<sup>495</sup> Prudential Regulation Authority, ‘Sharia –compliant liquid assets’, Occasional Consultation Paper (March 2014)

(iv) in the case of a simplified ILAS BIPRU firm only, investments in a designated *money market fund*.<sup>496</sup>

The second problem is concentration risk. Islamic banks are exposed to this type of risk due to the fact that there is only one asset that meets the eligibility criteria for their liquid asset buffer. It is reported that the concentration risk has created two further issues.<sup>497</sup> First, 'Sharia-compliant firms will optimise liquidity mismatch to a greater extent than similar non-Islamic firms would do, thus limiting balance sheet growth and the entry of Sharia-compliant firms.'<sup>498</sup> Second, 'the liquid assets buffer of Sharia-compliant firms is more concentrated than that of similar non-Islamic firms resulting in comparatively higher risks to the safety and soundness of Sharia-compliant firms.'<sup>499</sup> As a result, Islamic banks can be more fragile in the event of a financial crisis as opposed to their conventional counterparts.

Islamic banks and the conventional banks are vulnerable to liquidity risk; and both types of banking institutions are exposed to this risk in a similar way. As a result, the third problem is when the options for liquid assets available for both types of banking institutions are not the same. While the liquid assets instruments such as cash, Treasury Bills, Certificate of Deposits, Call Money Market, Commercial Paper, Bankers' Acceptance and government loans are available for conventional banks; this is not, however, the case for Islamic banks.

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<sup>496</sup> Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU) Clause 12.7 Liquid Assets Buffer via <<https://fshandbook.info/FS/print/FCA/BIPRU/12/7>> accessed : 10 March 2015

<sup>497</sup> Supra, Note. 357

<sup>498</sup> Ibid.

<sup>499</sup> Ibid.

In the money market, the liquid asset instruments available to maintain the liquidity of Islamic banks are limited. Islamic banks are not in the same position as the conventional banks, because the former cannot borrow at interest to meet unexpected withdrawals from their depositors. Since Islamic banks operate on Sharia principles, only Sharia-compliant liquidity instruments from a Sharia-compliant institution are allowed to be traded.<sup>500</sup> While cash is used as a liquid asset instrument in conventional finance, trading money with money is not allowed in Islamic finance (money does not have any value in the Islamic economy).<sup>501</sup> Sukuk is the most common liquidity instrument for Islamic banks. In the UK, the lack of sufficient quality sterling Sukuk recognised by the Bank of England poses liquidity challenges for Islamic banks despite it being argued that those banks are naturally 'over liquid'.<sup>502</sup> Thus far, the only eligible assets are Sukuk issued by the Islamic Development Bank (IDB)<sup>503</sup>. Other instruments are trade finance letters of credit or government-issued Sukuk.<sup>504</sup> Additionally, Islamic banks are said to rely on retail deposits as their liquidity source more than the conventional banks.<sup>505</sup> Notably, with regards to the liquid assets options,

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<sup>500</sup> European Banking Authority, Report on Impact Assessment for liquidity measures under Article 509 (1) of the CRR (December 2013), Appendix 11, p.246

<sup>501</sup> Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A comparative look at the United Kingdom and Malaysia*, (2011), p.27

<sup>502</sup> Richard Thomas, 'Liquidity Risk' in Rifaat Abdel Karim and Simon Archer, *Islamic Finance: The New Regulatory Challenge*, (2013) (ebruary), p.328

<sup>503</sup> Prudential Regulation Authority, 'Sharia-compliant liquid assets', Occasional Consultation Paper (March 2014)

<sup>504</sup> Ola Al-Sayed, 'Money Market Instruments in Conventional and Islamic banks', (2015), EIJSH (Vol1:3)

<sup>505</sup> Supra, Note. 502, p.331

the international Islamic finance regulator such as IFSB in its 2005 IFSB Guiding Principles were silent on the types of liquid asset to be held.<sup>506</sup>

The lack of ability to invest their surplus assets in the secondary market exposes Islamic banks to liquidity problems. It has been asserted that one of the reasons for the shortcomings is 'the lack of markets in which to sell, trade and negotiate financial assets of the banks.'<sup>507</sup> Moreover, the lack of an Islamic inter-bank money market on the scale of similar-sized conventional markets aggravates the existing liquidity issue.

<sup>508</sup>

Additionally, it is worth noting that, while Islamic banks may be facing failures due to their illiquidity; they may not be able to opt for Lender of the Last Resort from the Bank of England for liquid injection.<sup>509</sup> This is because, the funds of the Lender of Last Resort scheme may be invested in an interest-based transaction, and Islamic banks may be charged an interest rate by the Bank of England for the liquidity injection.<sup>510</sup> This problem is a challenge for Islamic banks, because they are not able to take part in interest-based transactions.<sup>511</sup> The issue of the ability of Islamic banks to borrow

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<sup>506</sup> Rodney Wilson, *Legal, Regulatory and Governance Issues in Islamic Finance*, (2012), p.127

<sup>507</sup> Zamir Iqbal, 'Challenges Facing Islamic Financial Industry', (2007), p.3

<sup>508</sup> Thomson Reuters, 'Issues in Islamic liquidity', (2007), IFR, via <<http://www.ifre.com/>> accessed 13 January 2015

<sup>509</sup> Supra, Note. 503

<sup>510</sup> Ibid.

<sup>511</sup> Ibid.

funds with the Bank of England remains unsolved.<sup>512</sup> It is not, however, the aim of this section to discuss this issue further.

In light of the fact that the liquid asset requirements in the existing regulation have been identified as limiting the growth of the Islamic banks in the UK,<sup>513</sup> the PRA's regulatory proposal states that Islamic banks should be allowed to have a wider set of assets in their liquid assets buffers. It is intended to 'help reduce the risks of concentration in Sharia-compliant firms' liquidity buffers and they are intended to help remove potential barriers to growth and entry.<sup>514</sup> Following this, the regulators proposed to recognise Sukuk issued by sovereigns with lower credit ratings and other Sukuk that are not issued by a member of the financial sector. Additionally, Sukuk issued by the highest-rated sovereigns may be included in a firm's liquid assets buffer without a haircut. The lower quality assets, however, would be subject to haircuts and caps.<sup>515</sup> The proposal is said to be in-line with Basel III Liquidity Coverage Ratio requirements. In certain circumstances, however, the PRA mentioned that it may increase the haircut to account for a less developed secondary market.<sup>516</sup>

Now that the issues arising from liquid assets in the existing regulation have been discussed, the questions are - to what extent does the liquid asset regulation for Islamic banks represent a level-playing field and have there been regulatory problems in creating a level-playing field for Islamic banks in the regulatory framework

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<sup>512</sup> Ibid.

<sup>513</sup> Ibid.

<sup>514</sup> Ibid.

<sup>515</sup> Ibid.

<sup>516</sup> Ibid.



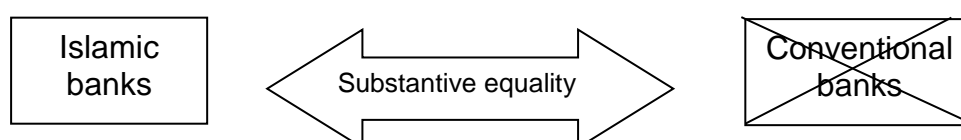
As mentioned in the earlier chapter, a level-playing field consists of two elements, which are equality before the law and the fair opportunity to compete. The difference between the two elements is in their contexts. For equality before the law, this element represents how the law treats the subjects - in particular, the legal accommodation. As mentioned in the previous chapter, equality before the law consists of formal and substantive equality. Whereas, fair opportunity to compete is the possibility of the subject being able to compete fairly based on the legal accommodation.

It can be asserted that the PRA's regulatory proposal delivers the element of formal equality. The practice is an indication that special regulatory accommodation would be given to Islamic banks on those issues that are regarded as critical for the survival of the institutions. It can be inferred that formal equality derives from the consultation process which has been mentioned in the previous section.

While formal equality appears to exist in the regulatory proposal, the issue is whether the approach by the regulators delivers the element of substantive equality? This question arises from the fact that Islamic banks are allowed to purchase lower-quality liquid assets (as opposed to the conventional banks, which will not be entitled to this flexibility). It can, therefore be said that there is leniency in the proposed regulation. This raises the question of substantive equality in the regulatory framework.

Substantive equality can be interpreted from two perspectives. Firstly, substantive equality arises on the part of Islamic banks. Secondly, substantive equality may not

exist on the part of the conventional banks. This statement is illustrated in the following diagram:



Source: Author's own

With regards to the first perspective, the facts outlined earlier have shown that there is substantive equality for Islamic banks when special regulatory accommodation is given to them due to the existing concentration risk. It is asserted that the concentration risk for Islamic banks is due to two main factors: (i) the regulators requirement of high liquid assets and (ii) the constraint faced by Islamic banks due to the first factor.<sup>517</sup> The flexibility of the regulatory proposal is, however, not applicable for conventional banks.

Generally, the UK's regulatory standard for high quality liquid assets (HQLA) means that the assets should contain high quality, unencumbered assets and maintain a prudent funding profile.<sup>518</sup> According to the Basel III Liquidity Coverage Ratio (LCR), the value of the ratio of liquid assets should not be lower than 100% in the absence of financial stress.<sup>519</sup>

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<sup>517</sup> Ibid.

<sup>518</sup> FCA and PRA Handbook, Rule 12.2.8R BIPRU

<sup>519</sup> Section 17 Basel III Liquidity Coverage Ratio via <<http://www.bis.org/publ/bcbs238.pdf> > accessed: 10 March 2015

As it is difficult for Islamic banks to hold Sharia-compliant liquid assets, an exception is given to them. It can be inferred that the exception has led to the creation of substantive equality by allowing Islamic banks to (i) purchase Sukuk with lower credit ratings and (ii) to purchase other Sukuk that are not issued by a member of the financial sector. In other words, the liquid asset quality for Islamic banks may have lesser quality in comparison with their conventional counterparts.

Following this, it can be argued that substantive equality only exists to a certain extent. This raises the issue of whether treating Islamic banks differently to conventional regulation will distort the level-playing field between the two types of institutions. This concern was highlighted by the UK regulators in the same consultation paper. Note that the question of a level-playing field was mentioned by the regulators in the following statement:

“Developing a definition of liquid assets specific to Sharia compliant firms which is different from the general definition ***may give rise to level playing field concerns***. However, unlike Sharia compliant firms, conventional firms can hold non-Sharia assets to meet their liquidity requirements and therefore the proposals would allow Sharia compliant firms to hold a similarly diverse liquidity buffer.”<sup>520</sup> (emphasis added)

Furthermore, the problem of a level-playing field was also mentioned by the European Banking Commission (EBA):

“The EBA suggests the possibility of waiving certain requirements for the holding of such assets under conditions clearly defined in the delegated act. However, the

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<sup>520</sup> Supra, Note. 503

resulting regime should not constitute a competitive advantage for such banks vis-à-vis non-Sharia compliant banks. Alternatively, a provision could be included in the delegated act to provide discretion for competent authorities to waive the liquidity coverage ratio (LCR) and/or requirements for HQLA on a case-by-case basis for Sharia-compliant banks. However, these alternatives are less favourable ***due to level playing field issues*** and comparability of banks' LCR positions.”<sup>521</sup> (emphasis added)

Both statements above indicate that treating Islamic banks and the conventional banks on a level-playing field is regarded as problematic by all parties – the regulators and the banking institutions, in the UK and internationally. From the statement above, it can be deduced that substantive equality as one of the elements in equality before the law does not exist. In particular, the conventional banks can be judged to have a disadvantage based on the proposed regulatory accommodation.

One may, however, argue that it is more important to look at the whole context of the regulatory accommodation itself. For example, the fact that the regulatory proposal allows Islamic banks to have lesser quality liquid assets; conceptually, the law does not disadvantage conventional banks. As mentioned earlier, the conventional banks are provided with bigger options on liquid assets as opposed to Islamic banks.

One of the principal objectives of banking regulation in the UK is to promote a fair opportunity for all banking institutions to compete. It can be asserted that the ‘fair

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<sup>521</sup> European Banking Authority, Report: ‘Impact Assessment for Liquidity Measures under Article 509 (1) of the CRR’, (December 2013), Appendix 11. At the European level, the European Banking Commission proposed the insertion of the ‘definition of the Sharia-compliant financial products as an alternative to assets that would qualify as liquid assets’ in the Capital Requirements Regulations.

opportunity to compete' in the regulatory framework for the banking institutions in the UK comprises two dimensions. On the one hand, the earlier regulation which provides the same regulation to all banking institutions in the UK is considered as providing a 'fair' opportunity for all banking institutions to compete. On the other hand, the recent regulatory proposal can also be considered as providing a 'fair' opportunity for Islamic banks to compete as it is aimed at resolving the liquidity management issue that is seen to impede the development of Islamic banks.

The regulatory proposal by the UK regulators, however, shows that the opportunity for all banking institutions to compete is fair only to a certain extent. On the one hand, it could be said that fairness does not exist due to the fact that the regulatory proposal does not provide the same regulation for all banking institutions in the UK. Arguably, if the 'fair' opportunity to compete can be a contributing factor to the objective of creating a level-playing field, ideally, the same regulations should be imposed on all banking institutions. For instance, in the current regulatory proposal; the regulators have proposed a dedicated regulatory accommodation on liquid assets for Islamic banks. Such an accommodation is viewed to be more flexible than what is imposed on the conventional banks thus raising the question of fairness in the regulation.

On the other hand, it can also be argued that the regulatory proposal is intended to promote a fair opportunity for Islamic banks to compete with conventional banks. This is because the flexibility given to Islamic banks reflects the fact that the regulators are working to provide a better solution to the issues faced by Islamic banks. The regulatory amendment should, therefore, be perceived in a wider context rather than a straightforward comparison of the regulatory treatment. For instance, the whole

contextual approach by the regulators is to promote Islamic banks in the UK. Hence, it can be argued that the regulatory accommodation does not necessarily provide a fair opportunity for all banking institutions to compete, but it helps to provide a better playing field for Islamic banks to continue to grow.

At the international level, in the past, the acceptance by the regulators that they should provide a legal accommodation to reflect the element of 'fair opportunity to compete' is somewhat different from the existing situation. The element of 'fair opportunity to compete' in the regulation for Islamic banks is not as clear in the international financial regulation. It was rather difficult to see that international financial regulators at the Bank of International Settlements (BIS) have the willingness to provide some attention to the issues faced by Islamic banks. Most of the regulatory decisions were made to focus on the dominant conventional banking industry, in particular, to internationally-active banks. As stated in the BCBS Charter, the Committee is given the mandate 'to monitor the implementation of BCBS standards in member countries and beyond with the purpose of ensuring their timely, consistent and effective implementation and contributing to a level-playing field among internationally-active banks'<sup>522</sup>. This mandate, however, does not seem to fit with the overall objective of the Basel Accords, which is 'to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It is also to promote monetary and financial stability in the banking sector worldwide.'<sup>523</sup> While these are the overall objective of the Basel

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<sup>522</sup> Article 2 of BCBS Charter via <<http://www.bis.org/bcbs/charter.pdf>> accessed: 10 March 2015

<sup>523</sup> Basel Committee on Banking Supervision via <http://www.bis.org/bcbs/>> accessed: 10 March 2015

Accords, neither the regulatory frameworks of Basel II nor Basel III were written with their application to the Islamic banking sector in mind.<sup>524</sup>

Recent evidence, however, has shown that international regulators such as the Basel Committee and the European Banking Commission have begun efforts to resolve the liquidity management issue for Islamic banks. Section 68 of the Basel III Framework on the Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools ('Treatment for Shariah-compliant banks'), which came into force in January 2013, as well as Section 509(1) of the Capital Requirements Regulation Directive illustrate this point. Nonetheless, despite the fact that the regulatory accommodation for the liquid assets of Islamic banks represents positive development, other regulatory concerns, which involve the liquidity issue in Islamic finance, remain unsolved. For instance, there is the issue of Sharia-compliant assets, which are not denominated in the currency of the third country that issues them (because the majority of sovereign Sukuk issuance is in US dollars). In addition the secondary market in Sukuk is comparatively less active and Sharia-compliant assets are not eligible collateral for the standard liquidity operations of a central bank in a member State.<sup>525</sup>

Notably, the lack of regulation, which suits the nature of Islamic banks in the international regulatory framework such as in the Basel Accords, is solved by the establishment of the international regulatory body, namely the Islamic Financial Services Board (IFSB). The IFSB aims to complement the lack of regulatory

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<sup>524</sup> Rifaat Abdel Karim and Simon Archer, *Islamic Finance: The New Regulatory Challenge*, (2015) (SOAS e-brary), p.4

<sup>525</sup> Supra, Note. 503, p.248

accommodation to suit the nature of Islamic banks in the Basel frameworks – hence the IFSB-12 Guiding Principles on Liquidity Risk Management for Institutions Offering Islamic Financial Services were established and took effect in 2012. The International Islamic Liquidity Management Corporation was also established by the IFSB in the year 2010 with the primary objective of issuing Sharia-compliant financial instruments to facilitate more efficient and effective liquidity management solutions for the Islamic financial sector.<sup>526</sup>

While international regulatory standards mainly to accommodate the nature of Islamic banks have been established by the IFSB for some considerable time, arguably, the regulators in the UK and the Basel committee seem reluctant to adopt the IFSB approach. It is however difficult to identify the reasoning behind this issue. It can be argued that one possible approach to fill the gap in the banking regulation is to have the conventional and Islamic banking regulatory bodies work together. For instance, the International Accounting Standards Board has taken steps towards working with the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) on developing accounting standards that are appropriate for the needs of Islamic financial institutions.<sup>527</sup> This approach could be taken by the Basel committee and the IFSB, working jointly to develop regulatory standards for Islamic banks.

In sum, despite the fact that the Islamic banking sector is comparatively small in comparison with the conventional banking sector, the relevance of the Islamic banking

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<sup>526</sup>Via <<http://www.ifsb.org/>> accessed: 9 January 2015

<sup>527</sup> Mohammed Amin, 'Accounting and Tax Development', via <[http://mohammedamin.com/Islamic\\_finance/Accounting-and-Tax-Developments-2014.html](http://mohammedamin.com/Islamic_finance/Accounting-and-Tax-Developments-2014.html)> accessed:10 March 2015



sector in the UK and in Europe has become increasingly significant. This has led the regulators to pay more attention to the issue of liquidity management for Islamic banks. Treating Islamic banks on a level-playing field within the conventional regulatory framework, however, certainly causes regulatory concerns. As posited by the regulators, since Islamic banks are unlikely to qualify for the liquidity coverage requirement, the absence of specific provisions, which accommodate the liquidity management issues, creates inconsistency in the regulation for the conventional and Islamic banking sectors. Furthermore, there is no similar-sized inter-bank money market for Islamic banks in comparison with the inter-bank money market of conventional banks – thus making it more difficult for Islamic banks to grow. As such, the regulators have taken the view that the issues faced by Islamic banks with regards to the liquid assets options could be a barrier to growth and entry to the financial sector. Based on the analysis above, it can be deduced that there are issues surrounding a level-playing field in existing regulation as well as in regulatory proposals. This therefore leads to the conclusion that the regulators are not able to create an absolute level-playing field in the regulation.

We now move on to the taxation treatment in Islamic financial transactions. It can be argued that taxation is not directly related to the subject of regulation. The fact is, however, that some legislative changes for taxation have been made by the regulator and so the question of a level-playing field, as enumerated in the legislation, leads to the discussion in the next section. Moreover, Islamic banks are affected by the regulatory accommodation on taxation for their retail mortgage products. The next section, therefore, analyses the taxation principles and practice within the context of a level-playing field in the regulation.

## (h) TAXATION

There is no precise definition of tax,<sup>528</sup> however, tax has been illustrated through its purpose, principles and policies. Tax is used 'to raise revenue for government expenditure', for the 'redistribution of wealth and income', to exercise 'control of the economy', for 'social control' and for making sure that the subjects 'pay the full price of something.'<sup>529</sup> The taxation policy of a country is often shaped through political, economic, social, and administrative pressures.<sup>530</sup>

The principles of taxation, as argued by Adam Smith, are mainly based on four basic principles:

- (i) The subjects must contribute taxes to the state in proportion to their revenue;
- (ii) Tax should be certain and not arbitrary;
- (iii) Every tax should be levied in a convenient way;
- (iv) The cost of imposing and collecting taxes is to be kept to a minimum<sup>531</sup>

In addition to the above principles it is asserted by Williams and Morse that taxes should be competitive internationally.<sup>532</sup> The latter's view is indeed significant for the UK to remain a competitive financial hub. UK taxation is also subject to European Union regulations,<sup>533</sup> hence the regulatory accommodation for taxation in Islamic finance is subject to EU directives.

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<sup>528</sup> Williams and Morse, *Davies: Principles of Tax Law*, (2012), p.3

<sup>529</sup> Ibid., p.3-5

<sup>530</sup> Ibid.

<sup>531</sup> Adam Smith, *The Wealth of Nations*, (1904), p.415-417 via <<http://site.ebrary.com/id/>> accessed: 20 September 2013

<sup>532</sup> Supra, Note. 528, p.10

<sup>533</sup> Ibid.

## PRINCIPLES AND POLICIES

At a macro-level, the taxation policies adopted by the UK government in its 2012 Budget should be 'simple, predictable, support work and they should be fair'<sup>534</sup>. In early June 2010, the Coalition Programme for Government set out the new approach to taxation policy making whereby;

"the tax system needs to be reformed to make it more competitive, simpler, greener and fairer. The Government wants to ensure that the tax system better reflects its values and priorities...and aimed to reform tax policy 'to restore the UK tax system's reputation for predictability, stability and simplicity' underpinned by 'greater transparency'."<sup>535</sup>

The approach to creating a level-playing field for the Islamic financial sector in the UK can be inferred when the Tax Technical Working Group (the 'Working Group') was established by the UK government in the year 2003. Its role is mainly to solve the taxation issues in Islamic finance<sup>536</sup> and the idea is to remove tax barriers in the Islamic financial sector that could potentially impede the sector's development.<sup>537</sup>

Notably, the UK policy for the taxation framework for Islamic finance is based on these principles:-

- (i) treatment should follow the economic substance of the transaction;

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<sup>534</sup> Chancellor of the Exchequer, Speech: *Budget 2012* (March 2012) via <http://webarchive.nationalarchives.gov.uk/> accessed: 15 August 2013

<sup>535</sup> HM Treasury & HMRC, 'Tax Policy Making: A New Approach', (2010), p.5

<sup>536</sup> HM Treasury, 'The Development of Islamic Finance in the UK: The Government's Perspective', (2008), p.14,16

<sup>537</sup> Ibid.

- (ii) treatment should be on the same basis as equivalent financial products that bear interest;
- (iii) ordinary tax rules should be applied where possible; and rules that give undesirable or unpredictable results should be amended.<sup>538</sup>

Some Islamic financial transactions can produce complexities in taxation. In particular, the double taxation incurred through the multiple stages of an Islamic financial transaction often led to Islamic financial products being more expensive than their conventional counterparts. This has ultimately exposed the Islamic financial sector to a lack of opportunity to compete with its conventional counterpart. (Although, based on this fact, a conventional banker may argue that multiple taxations do not necessarily produce a lack of fair opportunity to compete, because, if the Islamic financial contracts are genuinely expensive, then it should be fair enough for them to charge according to the multiple transactions. This would then produce a fair opportunity to compete between all financial services institutions).

Be that as it may, the level-playing field in the existing regulatory framework for Islamic finance taxation in the UK is based on three main options. Through the consultation process, three options are available to the regulator when deciding upon a regulatory proposal. The options are either to make legislative amendments, issue legal opinions or 'do-nothing'. The 'legal opinion option' was not chosen as it was considered that it would only lead to minimal competitive effect and the long-term uncertainty would not be removed. The 'do-nothing' option was not chosen as it was considered that it would not produce positive competitive consequences and would restrict the profitability of

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<sup>538</sup> Ibid., p.15

products offerings.<sup>539</sup> The government chose to make legislative amendments over the other two options as it is believed that legislative amendments would produce certainty in the taxation treatment for Islamic finance.<sup>540</sup>

Following this, in 2003, there were two legislative changes made to the Finance Act 2003 (FA 2003) under 'Alternative Property Finance'. Firstly, the FA 2003 introduced 'relief to prevent multiple payment of Stamp Duty Land Tax (SDLT) on Islamic mortgages'<sup>541</sup> and the relief from SDLT on a 'series of chargeable land transactions that are not necessary under conventional mortgage structures.'<sup>542</sup> Further legislative amendments were made in the Finance Act 2005 (FA 2005) and the Finance Act 2006 (FA 2006) for borrowing arrangement products (Murabaha and Diminishing Musharaka, Ijara); deposit arrangement products (Mudaraba and Wakala); asset finance products (Tawarruq, Istisna'); investment certificates (Sukuk) and derivatives (Option, Profit Swap, 'Urbun). Notably, in the year 2009 SDLT relief was granted on issuance, transfers or redemption of Sukuk subject to the conditions set out in the Finance Act 2009.<sup>543</sup>

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<sup>539</sup> Michael Ainley, Ali Mashayeki, Robert Hicks, Arshadur Rahman, and Ali Ravalia., 'Islamic Finance in the UK: Regulation and Challenges', (2007), p.8

<sup>540</sup> HMRC, 'Regulatory Impact Assessment' via <<http://www.hmrc.gov.uk/ria/ria-alt-finance.pdf>> accessed: 11 November 2013

<sup>541</sup> Supra, Note. 535, p.8

<sup>542</sup> Supra, Note. 396

<sup>543</sup> Schedule 61 Finance Act 2009

The next section highlights the taxation treatment of some Islamic financial contracts in the area of Stamp Duty Land Tax (SDLT), Corporation Tax and Value Added Tax (VAT) on Islamic finance arrangements.

#### **(i) STAMP DUTY LAND TAX (SDLT)**

SDLT is 'levied on all transactions involving the sale and purchase of land and buildings.'<sup>544</sup> Before 2003, in Islamic financial transactions involving property finance, SDLT was charged twice – upon a bank purchasing the property and secondly upon the property being resold to the customer.<sup>545</sup> Consequently, this double-taxation made Islamic finance more expensive than the conventional equivalent product where the customer is only charged once when the customer buys the property from a third party (whether using his own money or a bank mortgage).<sup>546</sup> Ultimately, the original treatment in Islamic finance real estate acquisition made the Islamic financial product less competitive than the conventional equivalent, hence leading to the lack of a level-playing field.

Facts have shown that the lack of a level-playing field issue in Islamic financial contracts was then solved by the UK government. Legislative amendments were made in the Finance Act 2003 to abolish the double-taxation treatment so that Islamic finance transaction bears the same SDLT cost as with a conventional property finance

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<sup>544</sup> Ken Englington, Nash Jaffer, Armughan Kausar, Alkis Michael in Craig R. Nethercott and David M. Eisenberg (eds), *'Islamic Finance: Law and Practice'*, (2012), p.85

<sup>545</sup> Mohamed Amin, 'Islamic Financial Products and their challenge to taxation systems' via <[www.mohammedamin.com](http://www.mohammedamin.com)>accessed:12 March 2015

<sup>546</sup> Ibid.

acquisition.<sup>547</sup> The relief on double-taxation is now granted to Murabaha and Diminishing Musharaka arrangements in real estate transfer provided that specified qualifying conditions are met:<sup>548</sup>

The situation with Ijara contracts is similar. Legislative amendments in 2003 provide taxation relief as the SDLT is not chargeable as long as the lessee is given the right to acquire the asset. Whereas, prior to the legislative amendments, SDLT was chargeable on (i) the purchase of the asset by the lessor (ii) on the lease to the lessee and (iii) at the disposal stage to the lessee. Notably, the fact that the regulatory approach for Islamic financial product is based on the economic substance of the contract, the Ijara contract is treated the same as the conventional lease agreement.

The legislative amendments which abolished the double SDLT treatment are seen as a positive step by the regulators to promote a level-playing field and promote a fairer opportunity for the Islamic financial sector to compete alongside conventional financial products. It may, however, be argued that treating one financial product as equivalent to another product leads to a lack of clarity. Nevertheless, such an issue may not arise if the regulation provides clear guideline. A positive aspect of the existing SDLT treatment is the fact that the regulator is referring to the economic substance of the Islamic financial transaction rather than its form thus reducing the need to have more regulation.

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<sup>547</sup> Section 73 Finance Act 2003 and Mohamed Amin, 'Islamic Financial Products and their challenge to taxation systems' via <[www.mohammedamin.com](http://www.mohammedamin.com)> accessed:12 March 2015

<sup>548</sup> Ibid.

## **(ii) CORPORATION TAX**

Corporation tax is charged on the profits returned by companies for any financial year.<sup>549</sup> For the Islamic financial transaction, the return is called the 'alternative finance return' - generally treated as interest in a conventional loan.<sup>550</sup> Changes were made to the Finance Act 2005 and Finance Act 2006 for the corporate taxation on the profits from Islamic financial transactions.<sup>551</sup> The return from Islamic financial transactions is tax deductible subject to specific conditions in the legislation. For example, the alternative finance return payable under Diminishing Musharaka as well as the return from the unrestricted investment account of a Mudaraba contract is taxed in a similar way to the interest payable on a conventional loan – hence tax deductible.<sup>552</sup>

In the existing regulatory framework, the legislative amendments on the corporate tax treatment for certain Islamic financial contracts are treated as equivalent to another Islamic financial contract.<sup>553</sup> This is done where the regulator deems that there are structural similarities between one Islamic financial contract and another. For

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<sup>549</sup> Part 2 Section 2 Corporation Tax Act 2009

<sup>550</sup> Nicholas Jessop, 'The Taxation of Islamic Finance in the UK: An Introduction', (2009-2010), p.22

<sup>551</sup> Ibid. p.21

<sup>552</sup> Finance Acts 2005, Section 47A and Section 49. "The funds of Unrestricted Investment Account are invested at bank's discretion, normally in the same asset pool as that in which the bank's own funds and those from current placed. As opposed to the funds of Restricted Investment Account where they are invested in asset pools that are separately designated and distinct from the bank's own funds and thus do not appear in the bank's balance sheet" quoted in Simon Archer and Rifaat Abdel Karim, 'Corporate Governance, Market Discipline and Regulations of Islamic Banks', (2006), p.2. 'Restricted Investment Account is taxed in the same way as for the conventional investment management industry.' Ken Englington, Nash Jaffer, Armughan Kausar, Alkis Michael in Craig R. Nethercott and David M. Eisenberg (eds) *'Islamic Finance: Law and Practice'*, (2012), p.108

<sup>553</sup> Supra, Note. 544, p.85-86



example, contracts such as Istisna', Parallel Istisna' and Wakala – these contracts are treated similar to Murabaha contracts. In these contracts, subject to specified conditions, the banks' profit return is tax deductible. Similarly Islamic financial contracts such as Tawarruq are also viewed as having structural similarities to Murabaha transactions, therefore, subject to fulfilling conditions prescribed in the legislation, - the corporate taxation is treated in the same way.

The element of formal equality can be inferred in the existing regulatory treatment for some Islamic financial contracts where the tax treatment for the latter is treated in a similar manner to conventional financial contracts. In Islamic financial contracts such as Constant Musharaka, this contract is treated as a partnership contracts. Following the corporate tax treatment of a conventional partnership, the underlying profits will be taxed onto the partners individually rather than the partnership itself. Accordingly, if trading activities are undertaken in the UK, the partners will be taxed based on their share of trading profits.<sup>554</sup> For contracts such as Ijara, they are treated in a similar manner to conventional leases and for Sukuk, they are taxed in the same way as the return from a conventional bond.<sup>555</sup> For Tawarruq, Murabaha and the other Islamic financial contracts above, which are treated the same as Murabaha – these contracts are treated in the same way as conventional loans.<sup>556</sup>

The level-playing field in the regulation reflects the simplistic approach taken by the regulator, where the existing corporate tax treatment of conventional products is also

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<sup>554</sup> Ibid.,p.109

<sup>555</sup> Ibid. p.96, 114

<sup>556</sup> Ibid.,p.87-94

implemented for Islamic financial products. It can be argued that such an approach is a fairer way to accommodate tax treatment hence aligned with the principle of taxation policy for Islamic financial transactions. As of now, it is unforeseeable that the regulatory accommodation for corporation tax will produce any issues for the Islamic financial sector. It is also unforeseeable that the effect of the existing regulatory accommodation could result to an unfair advantage for Islamic finance to compete against conventional finance.

### **(iii) VALUE-ADDED TAX (VAT)**

VAT is 'a tax that is charged on most goods and services that VAT-registered businesses provide in the UK' as well as to 'goods and some services that are imported from countries outside the European Union (EU) and brought into the UK from other EU countries.'<sup>557</sup> Standard VAT rates are imposed differently by EU Member States. Usually the rates are charged between 15% and 25%.

In the year 2006, the UK issued VAT Information Sheet 11/06 which provides for the VAT treatment of Islamic financial products. The information sheet is intended to supplement the HMRC<sup>558</sup> guidance. In other words, the specific rulings provided in the VAT information sheet are to be applied concurrently with VAT rulings provided by the HMRC guidance notes.

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<sup>557</sup> Value-Added Tax via <<http://www.hmrc.gov.uk/vat/>> accessed: 10 October 2011, See also Section 1, VAT Act 1994

<sup>558</sup> Her Majesty's Revenue & Customs

The level-playing field in the regulatory framework representing the VAT treatment for Islamic financial products in the UK are based on the nature and type of the transaction.<sup>559</sup> It can be argued that following this treatment, the formal equality principle is applied by the regulators whereby the application of VAT rulings for Islamic financial contracts is that they are to be treated no differently than conventional financial products. For example, the VAT Information Sheet 11/06 treats Murabaha transactions involving goods and property in a similar manner to conventional credit sales, the Ijara transaction as a basic leasing product, Wakala as an investment product (treated similar to Mudaraba) and Sukuk is treated similar to the conventional bond.<sup>560</sup>

In some circumstances, however, the VAT treatment for certain Islamic financial products could lead to the lack of level-playing field for the Islamic financial sector to compete against its conventional counterpart. For example, under the Diminishing Musharaka transaction, the customer has to pay VAT for the lease and the sale of the beneficial interest. In contrast the conventional repayment mortgage is VAT exempt. This makes the Diminishing Musharaka contract more expensive and less competitive than the conventional repayment mortgage.<sup>561</sup>

In another example, facts have shown that there is a lack of regulatory standardisation in the VAT treatment pertaining to the capacity of the Islamic financial contract. This

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<sup>559</sup> VAT Information Sheet 11/06

<sup>560</sup> VAT Information Sheet 11/06. The specific Vat treatment for Sukuk was not provided in the VAT Information Sheet. Sukuk follows the VAT rulings on conventional bonds. See, Ken Englinton, Nash Jaffer, Armughan Kausar, Alkis Michae in Craig R. Nethercott and David M. Eisenberg (eds), *'Islamic Finance: Law and Practice'*, (2012), p.116

<sup>561</sup> Practice Note: Sharia-Compliant Transactions via <[www.practicallaw.com](http://www.practicallaw.com)> accessed May 2014

can be inferred in Wakala and Mudaraba contracts <sup>562</sup> where the VAT treatment depends on whether the Islamic bank is acting in a restricted or unrestricted capacity.

Should the Islamic bank be acting in a restricted capacity (where the Islamic bank follows the customer's decision on their investment), the 'additional revenue made by the bank on the investment of the capital will be taxable at the standard-rate.'<sup>563</sup> This is because the HMRC regard such transactions by the Islamic bank as a form of portfolio or investment management. On the other hand, should the Islamic bank act in an unrestricted capacity (where the Islamic bank is making its own investment decisions), the 'additional profit made by the bank will be outside the scope of VAT.'<sup>564</sup> The VAT treatment represents the application of the existing conventional taxation rulings; however, the outcome of this treatment leads to the conclusion that the unrestricted position of the Islamic bank would be more cost-efficient for the customer. Therefore, should the Islamic bank be in a restricted position - the VAT charge levied upon the Islamic bank may make this investment option unattractive.<sup>565</sup>

To conclude, the existing taxation treatment for Islamic financial products is designed to suit the taxation framework as laid down by HMRC. In the context of a level-playing field, the regulator has made several legislative amendments to allow a more level-

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<sup>562</sup> Wakala contract is an investment product which functions similar to the Mudaraba contract. However the difference between these two is that all of the profit in the Mudaraba contract is divided between the parties. Whereas in Wakala contract, the investor receives only the agreed ratio against investment. Thus, returns made above the agreed ratio is kept by the Islamic bank and not given to the investor. Notably, Mudaraba savings account is treated as conventional savings account. See, VAT Information Sheet 11/06

<sup>563</sup> VAT Information Sheet 11/06

<sup>564</sup> Ibid.

<sup>565</sup> Ibid.

playing field for Islamic financial products. Nonetheless, the legislative amendments were made with reference to the taxation principles and based on the practicality of having amendments. Based on the existing treatment, the level-playing field regulation shows that the economic justification is considered to be more significant than the legal justification. Hence, while the structure in form is different from one contract to another, nevertheless, what is looked at is the substantial structure of a contract.

### **3.3 CONCLUSION**

This chapter has analysed the regulatory accommodation governing Islamic banks in the UK from the context of a level-playing field. Arguably, there is no clear indication by the UK's regulators as to what exactly level-playing field means in the context of regulation. The findings of the analysis suggest that the regulatory accommodation governing Islamic banks in the UK does not fully represent the idea of level-playing field regulations. As discussed in the previous chapter, a level-playing field comprises the element equality before the law. Equality before the law is represented through the regulators' effort to apply the element of formal and substantive equality through legislative amendments. The principle of formal equality applied by the UK's regulators has led to two conclusions - first, where substantive equality is met in some cases and second, inequality at the substantive level exists. The inequality at the substantive level arises due to the fact that the regulators chose not to amend the law after considering the economic benefits of such a change.

The results of the investigations show that the UK's regulators were selective when making regulatory amendments for specific Islamic financial products and,

consequently, all the issues within the Islamic financial sector at the substantive level were not considered. In fact, in most instances, Islamic financial services have had to make substantive compromises in order to serve the formal equality. Hence the principle of substantive equality is hardly achieved. As substantive equality is compromised, the law cannot be considered as an ideal law. Nevertheless, it can also be argued that the absence of an ideal law does not necessarily mean it is an invalid law.

The general findings above have led to the second major observation whereby the impact of the existing level-playing field regulations have exposed Islamic banks to several types of risks; such as reputational risk, operational risk, transparency risk and regulatory risk. In terms of the authorisation process, substantive compromises have to be made by Islamic banks wishing to operate in the UK. For instance, despite the fact that the nature of Islamic banks is based on the profit-loss sharing model, Islamic banks have had to compromise the PLS model in order to fulfil the level-playing field regulations. Under these regulations, Islamic banks have to resort to using the Deposit Guarantee Scheme in which funds are pooled and mixed with the conventional funds. This has led Islamic banks to become exposed to operational risk and reputational risk.

The capital certainty requirements have also led Islamic banks to compromise the PLS model in order to fulfil the formal equality requirement because they are regarded as depository institutions (It has been argued earlier that the capital certainty requirements bring more benefit for Islamic banks. However, although it can be said

that the capital certainty requirement would not cause any serious risk to Islamic banks, one can also argue that it affects the operational aspect of Islamic banks (operational risk) because of the actual nature of Islamic banks which is based on PLS model, and this may lead Islamic banks to face reputational risk). Additionally, where the kind of regulations applicable to Islamic banks are based on the type of banking business which an Islamic bank wishes to offer (depository or investment institution) the level-playing field regulations may not be able to accommodate the specific type of Islamic banking business due to the vague status (depository or investment institution) arising from its inherent nature of banking business. Therefore, regulatory uncertainties can arise if the regulators and/or Islamic banks cannot determine the most appropriate category of service / investment they wish to offer under the conventional regulatory framework.

It was also shown that the level-playing field regulations causes some regulatory uncertainties and suffers from a lack of regulatory clarity. For instance, in the case of Sukuk, it was highlighted that not all type of Sukuk are given specific regulatory accommodation based on its nature. The level-playing field regulations under the conventional regulatory framework only provide specific regulatory accommodations for Sukuk which produces similar economic substance than the conventional bonds. In other words, the UK's regulators refer to the substance of Sukuk transaction rather than its form. However, as mentioned earlier, this should not be a problem if the regulators understand the product fully. Lack of regulatory uncertainties can only occur if there is a lack of understanding with regards to the type of Sukuk that matches the conventional regulation. Notwithstanding these limitations, a positive aspect of the

level-playing field regulations within the UK regulatory framework is where Sukuk that is a public debt is subjected to listing requirements, which is similar to the treatment of conventional bonds, and this enhances transparency and minimises regulatory arbitrage.

In another aspect, the level-playing field regulations on Home Purchase Plan has led to a lack of regulatory certainty and clarity due to the terminology used by Islamic banks and the definition of Home Purchase Plan provided by the regulators. The practice indicated by the Islamic bank suggests a different arrangement than that suggested in the context of the regulations.

The level-playing field regulations within the conventional regulatory framework have also shown that there is no preference on the part of the UK's regulators as to how Islamic banks' wish to operate. The element of equality before the law (formal equality and substantive equality) shows that no regulatory accommodation is imposed to Islamic banks pertaining to a Sharia Supervisory Board (which is regarded as crucial for Islamic banks) and how the supervision of Islamic banks should take place as part of their corporate governance. In this regard, the absence of regulation may expose Islamic banks to operational risk for the fact that they can operate according to how they wish.



With regards to Islamic financial disputes before the English courts, the practice has suggested that formal equality exists where Islamic finance cases are treated under common law principles. Nonetheless, it has been argued earlier that the English courts have not fully disregarded the Sharia-compliant aspect of the contract where expert witnesses have been called to testify. However, it can be suggested that there should be an establishment which consists of Sharia experts in the UK at the national level (similar to the National Sharia Advisory Council established by the Malaysian regulators) to decide on cases involving the substantive question on the legitimacy of the transaction in an Islamic finance contract.

Other positive findings under the level-playing field regulation for Islamic banks in the UK are pertaining to the regulatory decision making process, the regulation on taxation, as well as the Sharia-complaint liquid assets regulation. However, for the latter, it was found that while there is equality at the substantive level for Islamic banks, substantive equality may not exist on the part of the conventional banks as Islamic banks are allowed to have lower quality of assets. This causes a lack of opportunity for conventional banks to compete with Islamic banks and a lack of regulatory standardisation.

The overall findings of this chapter's analysis suggest that the regulators have not enabled the level-playing field regulations for Islamic banks in the UK. This is because, while in some cases there is the positive impact of the level-playing field regulations, the majority of the cases show that the level-playing field regulations have not been

effective hence poses risks to Islamic banks. Ultimately, the level-playing field regulations can be said as not a useful concept. However, there is yet to be a grievous issue pertaining to the existing regulatory accommodation which totally hinders Islamic banks from developing. Taken together, Islamic banks in the UK still have the opportunity to resort to a consultation process with the regulators for any arising issues. Nevertheless, the absence of appropriate regulations could adversely affect Islamic banks' ability to compete fairly with the conventional banks and ultimately to develop to its fullest extent. This then leads to the question of whether Islamic banks should be given more regulation which will be discussed in Chapter five. Before proceeding to this issue, it is necessary to examine the level-playing field regulations for Islamic banks in Malaysia. This is the focus of the next chapter.

## **CHAPTER FOUR: THE REGULATORY FRAMEWORK OF ISLAMIC BANKS IN MALAYSIA**

### **4.1 INTRODUCTION**

#### **4.1.1 THE PAST AND PRESENT REGULATORY SYSTEM GOVERNING ISLAMIC BANKS**

#### **4.1.2 THE GOVERNMENT'S APPROACH – PRINCIPLES AND POLICIES FOR ISLAMIC BANKS**

### **4.2 LEVEL-PLAYING FIELD AND THE REGULATORY ACCOMODATION FOR ISLAMIC BANKS**

#### **(a) AUTHORISATION**

#### **(b) SHARIA SUPERVISORY BOARD**

##### **(i) 'Fit and Proper' Criteria**

##### **(ii) Competent Requirement**

#### **(c) ISLAMIC FINANCE CASES BEFORE THE MALAYSIAN COURTS**

#### **(d) SHARIA-COMPLIANT LIQUIDITY MANAGEMENT REGULATION**

#### **(e) TAXATION - PRINCIPLES AND POLICIES**

##### **(i) Income Tax**

##### **(ii) Real Property Gains Tax**

##### **(iii) Stamp Duty Tax**

### **4.3 CONCLUSION**

## 4.1 INTRODUCTION

The preceding chapter analysed level-playing field within the regulatory framework of Islamic banks in the UK. The UK regulators have set a benchmark that all banks are subject to the conventional regulatory system thereby achieving uniformity within the diversity of the financial system. Hence the expression of level-playing field is demonstrated by regulators' treatment for all types of banks operating in the UK, in which the uniformed regulation caters for the diversity of the financial system. The diversity that exists in the UK financial system has allowed some regulatory development for Islamic banks to a certain extent. It has been argued that while the UK regulators encouraged the development of Islamic banks in its financial system, there are still some areas of the law which exposes Islamic banks to potential risks that ultimately impede the development of Islamic banks. It has been observed that the UK regulators' approach towards Islamic banks is reactive. Therefore, it is concluded that the level-playing field regulation in the UK is not a meaningful concept.

It has been mentioned in the introductory chapter that a similarity between the UK and Malaysia is that these two countries practice the common law system, but the approach to regulating all financial services institutions on a level-playing field differs. In treating the Islamic financial sector on a level-playing field, Malaysia has established a dual regulatory framework to separate the Islamic and conventional financial sectors. As opposed to the UK's reactive approach, the Malaysian regulatory framework for Islamic banks is considered to be proactive. Detailed regulations were set out by the regulators, ranging from institutional aspects to the specificity of each Islamic financial contract.

The outcome of the dual regulatory framework is that it provides a better platform for Islamic banks to develop its Sharia-compliant branding as well as a fairer system for Islamic banks to compete with the conventional banks. The dual regulatory system has also promoted transparency at the institutional and transactional level. Additionally, it can be seen that the dual regulatory framework, in theory, could minimise certain types of risks such as liquidity risk, reputational risk and legal risk. However, in practice, there are still areas of the law within the dual regulatory framework that do not align with the notion of level-playing field and still exposes Islamic banks to risks. The unique nature of the existing dual regulatory framework which is made to treat Islamic banks and conventional banks on a level-playing field therefore raises the same question as those raised in the UK chapter - to what extent do the Malaysian regulators enabled a level-playing field for Islamic banks?

Following this, the current chapter analyses the regulatory accommodation governing Islamic banks in Malaysia by focusing on the issue of level-playing field in the dual regulatory framework and examining the impact of the level-playing field regulations in the existing dual regulatory framework. The same approach as the previous chapter is used. This chapter therefore questions the regulatory clarity, transparency, standardisation and risks attached to Islamic banks.

Note that the discussion in this chapter is rather limited and lesser arguments can be found in this chapter as opposed to the discussion in the UK chapter (chapter three). This is because, the fact that the Malaysian government has established a dual regulatory framework for the Islamic banking and financial sector, lesser substantive

issues for the sector are involved as opposed to the UK's regulatory framework. In particular, this research does not contain certain section of which contained in chapter three. For instance, it is not intended to discuss the regulatory decision making process in this chapter due to the fact that there is no arising issue within the context of level-playing field.<sup>566</sup> Therefore, it can be seen that the discussion in this chapter is rather limited in comparison with chapter three.

This chapter consists of three main sections. It begins with a brief history of regulatory policies and the Islamic banking sector's development in Malaysia. The second section examines the regulatory accommodation for Islamic banks in the context of a level-playing field and analyses whether the Malaysian regulators have in fact enabled level-playing field treatment for Islamic banks. The third section provides some conclusions.

#### **4.1.1 THE PAST AND PRESENT REGULATORY SYSTEM GOVERNING ISLAMIC BANKS**

As stated in the first chapter, the first Islamic financial institution in Malaysia was formed in 1963 with the establishment of Tabung Haji (the Pilgrimage Fund). The real drive towards developing the Islamic financial services sector did not, however, begin until 20 years later, when the first Islamic bank called Bank Islam Malaysia Berhad (BIMB) was established in 1983. Later, in 1999, the second fully-fledged Islamic bank was established; namely Bank Muamalat Malaysia Berhad.<sup>567</sup> Since then, the Islamic

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<sup>566</sup> Moreover, the limited discussion in this chapter has proven the argument in chapter one (on the limits of comparative law research) whereby in comparative law research, no comparison on a particular research can be of the same.

<sup>567</sup> Global Islamic Finance Report 2011, p.164

financial services industry in Malaysia has continued to flourish and now numbers 16 fully-fledged Islamic banking and financial institutions (IFIs), 11 Islamic windows, four international IFIs, and 16 Takaful (Insurance) companies.<sup>568</sup>

Today, the Islamic finance sector in Malaysia is governed within the purview of:

- the Ministry of Finance,
- the Central Bank of Malaysia (CBM) - responsible for the monetary and financial stability in the Malaysia,
- the Securities Commission of Malaysia (SC) - regulates and authorise the enforcement of the Malaysian capital market,
- the Labuan Financial Services Authority (Labuan FSA) - acts as an authoritative body for international business and financial services institutions in Labuan,
- the Inland Revenue Board (IRB) - administers stamp duty and taxes,
- Bursa Malaysia (Bursa-Mal) - exchange company for listing, trading, clearing, settlement and depository services, and
- the Labuan Financial Exchange (LFX) - a similar exchange company as Bursa-Mal which does listing and trading of financial instruments for financial services sector in Labuan. <sup>569</sup>

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<sup>568</sup> 'Malaysia's Islamic Finance Marketplace', (2013) via <<http://www.mifc.com/index>> accessed: 10 October 2013 and *EY Global Takaful Insights*, (2013), p.62

<sup>569</sup> Global Islamic Finance Report 2011, p.163

In 1983, the first Islamic finance legislation was enacted – the Islamic Banking Act 1983 (IBA1983).<sup>570</sup> It is considered to be the first legal instrument in the world to comprise provisions governing fully-fledged Islamic banking and financial institutions (excluding Takaful companies).<sup>571</sup> Takaful companies were governed in separate legislation – the Takaful Act 1984. IBA 1983 did not govern Islamic banking windows, instead, the latter were governed by the Banking and Financial Institutions Act 1989 (BAFIA) – the legislation governing conventional banks. Notably, the Islamic windows system did not begin until 1993, when the ‘usury-free banking scheme’, which later became known as the ‘Islamic banking scheme’, was introduced whereby the funds derived from Islamic banking window transactions were separated from the conventional banks.<sup>572</sup> The IBA 1983 has now been repealed and replaced by the Islamic Financial Services Act 2013 (IFSA 2013). Similarly, BAFIA 1989 was repealed and replaced by the Financial Services Act 2013 (FSA 2013).

Apart from IFSA 2013 and FSA 2013, Islamic banking and financial institutions in Malaysia are also governed by several other pieces of legislation including, but not limited to, the Government Investment Act 1983, the Development Financial Institution Act 2002 (DAFIA 2002) and the Central Bank of Malaysia Act 2009 (CBA 2009).<sup>573</sup>

Strong governmental support for the Islamic financial services sector has positioned Malaysia as one of the most developed Islamic finance markets in the world. Several bodies were established by the Malaysian government such as the Islamic Capital

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<sup>570</sup> Ibid., p.164

<sup>571</sup> Islamic Banking Act 1983

<sup>572</sup> Global Islamic Finance Report 2011, p.164

<sup>573</sup> Ibid.



Market (ICM), the National Sharia Advisory Council (NSAC) (the highest Sharia authority for Islamic finance in Malaysia), the Law Harmonisation Committee (the Committee that reconcile and harmonise the Malaysian laws and Islamic financial contracts), the Malaysia International Islamic Financial Centre (MIFC) (the Centre for Islamic financial activities), the Malaysian Deposit Insurance Corporation (MDIC) (a company that protects depositors against the loss of their deposits in the case of bank's failure – the scheme provided is available for Islamic banks' depositors), academic and research centres such as - the Institute of Islamic Banking and Finance Malaysia (IBFIM), the International Centre for Education in Islamic Finance (INCEIF), the International Sharia Research Academy for Islamic Finance (ISRA). There is also the Securities Industry Development Corporation (SIDC) (a learning centre for capital markets in Malaysia). Malaysia is also the host country for the Islamic Financial Services Board (IFSB) (an international standards-setting regulator for the Islamic financial sector) and the International Islamic Liquidity Management Corporation (IILM) (an international body that facilitates cross-border Sharia-compliant liquidity management).<sup>574</sup>

#### **4.1.2 THE GOVERNMENT'S APPROACH – PRINCIPLES AND POLICIES FOR ISLAMIC BANKS**

Malaysia adopts a dual regulatory framework, which enables the conventional and Islamic financial services to operate in parallel. It can be seen that the creation of a dual regulatory framework is an indication of a serious effort by the Malaysian government to treat all financial services on a level-playing field. This can be evidenced from the legislative enactment whereby the creation of IBA 1983, which

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<sup>574</sup> Supra, Note. 433

specifically governed the fully fledged Islamic banks, is separate from BAFIA 1989, which governed the conventional banks. The abolition of these two pieces of legislation followed the more recent enactment of IFSA 2013 and FSA 2013 that aim to develop a better regulatory framework for both conventional and Islamic financial services. The Central Bank of Malaysia (CBM) commented that with the creation of these two pieces of legislation, 'the Bank (CBM) will be able to provide an appropriate level of oversight over financial holding companies to ensure that the activities of financial groups do not pose undue risks to the safety and soundness of financial institutions.'<sup>575</sup> Moreover, the CBM believe that the new legislation could 'maintain a clear focus on risk and fair conduct towards consumers while allowing for differentiation between financial institutions, supports healthy competition and productive innovation', and improve regulatory efficiency, as well as providing necessary safeguards for a sound financial system.<sup>576</sup>

In furtherance to the idea of treating all the banking and financial services institutions in Malaysia on a level-playing field, the KLRCA i-Arbitration Rules were established in 2012 to provide dispute resolution for Islamic finance disputes, which includes the Sharia-compliant aspects of the contracts. Notably, the Rules adopt the UNCITRAL Arbitration Rules, which were devised for Islamic finance dispute resolutions.<sup>577</sup>

The regulatory principles and policies for Islamic banks in Malaysia have evolved starting from detailed and prescriptive rules and moving towards a principles-based

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<sup>575</sup> Bank Negara Malaysia (BNM), *Financial Stability and Payment Systems Report 2012*, p.7

<sup>576</sup> Ibid., p.61

<sup>577</sup> Kuala Lumpur Regional Centre for Arbitration (KLRCA) via <<http://klrca.org/about/>> accessed: 29 May 2015

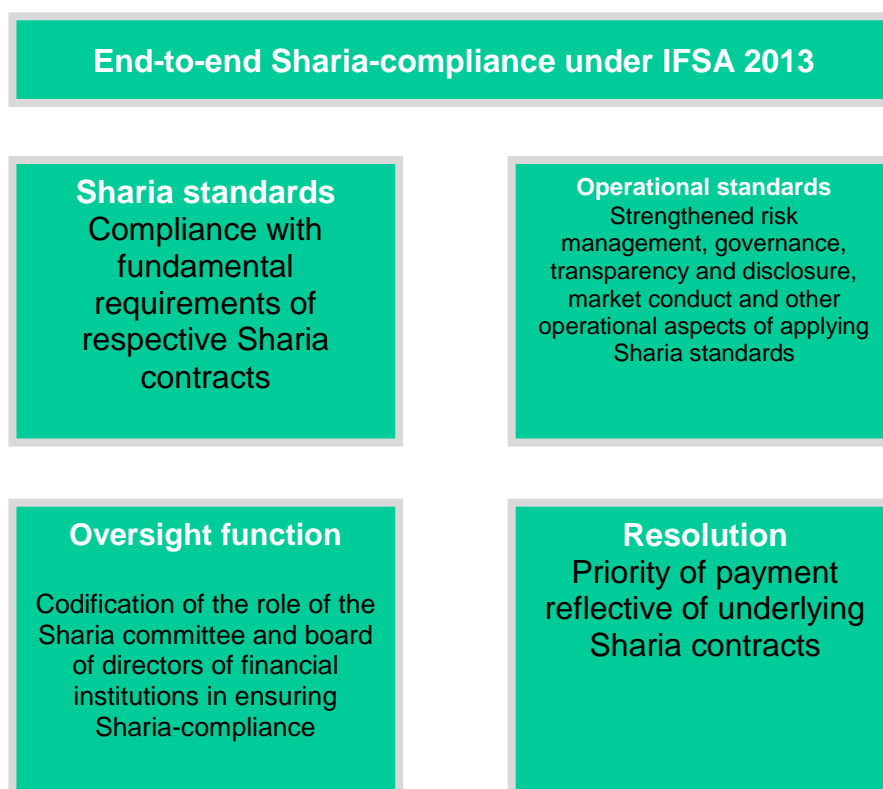
approach.<sup>578</sup> Although this approach is the same as the UK practice, the concept of its implementation differs slightly with the Malaysian regulatory framework giving special attention to the specificity of the Islamic financial contracts. In addition, therefore, to the principle-based approach, which is also being implemented in the conventional financial services sector, the regulatory framework governing Islamic banks in Malaysia is also a contract-based regulatory framework. The contract-based regulatory framework, as viewed by the Malaysian regulators, will reinforce Sharia principles, which could help to maintain the financial stability of the Islamic financial sector. In contrast to the Malaysian practice, the contract-based regulatory framework does not exist in the UK, because the UK regulators chose to allow Islamic banking and financial institutions to operate independently as long as the financial products are in compliance with the regulations provided by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

The rudimentary principle underlying the Malaysian contract-based regulatory approach is based upon end-to-end Sharia governance and compliance in the Islamic financial services sector within the IFSA 2013 legislative framework.<sup>579</sup> The diagram below shows the contract-based regulatory framework governing Islamic banks in Malaysia:

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<sup>578</sup> Supra, Note. 575, p.90

<sup>579</sup> Ibid., p.80



Source: BNM, Financial Stability and Payment Systems Report 2012

The regulatory framework mentioned above is aimed at reducing the legal and operational risk in Islamic financial transactions.<sup>580</sup> Section 6 of the IFSA 2013 inserts the principal regulatory objectives of the Act, which is to promote financial stability and compliance with Sharia objectives. By these principles, the CBM aims to foster:-

- (i) the safety and soundness of Islamic financial institutions;
- (ii) the integrity and orderly functioning of the Islamic money market and Islamic foreign exchange market;
- (iii) safe, efficient and reliable payment systems and Islamic payment instruments;
- (iv) fair, responsible and professional business conduct of Islamic financial institutions; and

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<sup>580</sup> Bank Negara Malaysia, *Financial Sector Blueprint 2011-2020*, p.36

- (v) strive to protect the rights and interests of consumers of Islamic financial services and products.

Other policies includes maintaining the stability of the overall financial system, enhancing the resilience of financial institutions through sound risk management practices and strengthening market confidence in, and the competitiveness of, the Islamic financial system.<sup>581</sup>

With regards to the policy objective enumerated in the IFSA 2013, the legislation, however, did not expressly mention that the regulators aimed to provide a level-playing field between Islamic financial services and conventional financial services. In spite of this, the creation of separate legislation in IFSA 2013 and FSA 2013 is seen to provide an implied understanding that there is an idea of a level-playing field behind the dual regulatory framework. As such, the Malaysian approach is in contrast with the UK approach, where the government expressly states the level-playing field approach for all types of financial services requires no separate regulatory framework. Despite the differences in the regulatory framework, it can be argued that, while the dual regulatory framework represents level-playing field treatment for Islamic and conventional banks, the general framework of IFSA 2013 contains rather similar wording and provisions to FSA 2013 in almost all parts of the entire legislation, apart from the fact that specific sections such as in Parts IV, VI and X of IFSA 2013 are dedicated to Islamic financial institutions and wording has been inserted such as 'Islamic' or 'Sharia'. In other words, FSA 2013 and IFSA 2013 is twin-legislation,

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<sup>581</sup> Supra, Note. 575, p.41

although there are some improvements in IFSA 2013 when compared to the previous Islamic Banking Act 1983.

Such an argument was also made by Rodney Wilson, when, in 2012, he argued that the separate legislation (the then Islamic Banking Act 1983) for Islamic banks had not seen much progress over the past three decades in Malaysia. The unique features of the Islamic banking sector or specific requirements for Sharia-based financing were not reflected in the separate legislation. He argued that:

“In short, although the Islamic Banking Act of 1983 was a commendable attempt to ensure that Islamic bank operations in Malaysia were put on a sound footing and there is *little reference to the unique features of Islamic banking or provision for the specific requirements of Sharia-based financing*. There has been much progress on these matters over the last three decades in Malaysia, *but this has not yet been reflected in the legislation which remains largely unchanged*.”<sup>582</sup> (emphasis added)

Such issues pertaining to the content of Islamic finance legislation raise the question of the real need to have separate legislation for the Islamic financial sector instead of incorporating the issues into a single piece of legislation. In particular, does the idea of treating all the banking and financial institutions on a level-playing field really require dual legislation or is the incorporation of Islamic financial provisions into conventional legislation sufficient? It is not, however, within the scope of this thesis to discuss the issue of single or dual legislation further. This is because such a question would require more focus on the constitutional law aspect, which is rather different from the current focus and objective of this thesis.

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<sup>582</sup> Rodney Wilson, *Legal, Regulatory and Governance Issues in Islamic Finance*, (2012), p.107

Notably, the dual regulatory framework in Malaysia reflects that the regulators perceived the effectiveness of level-playing field regulations when Islamic banks are accommodated separately from the conventional banks. While the Malaysian government strongly promotes a separate framework that represents a level-playing field for both banking and financial services, evidence has shown that more attention is being given to the Islamic financial services sector than its conventional counterpart. For instance, the regulators have inserted a specific provision that requires the CBM to promote Malaysia as an international hub for the Islamic financial services sector *per se*.

Section 60 of the CBA 2009 provides that the CBM;

“shall incorporate with the authority or international or supranational, organisation, develop and promote Malaysia as an international Islamic financial centre.”<sup>583</sup>

It can be argued that the term ‘shall’ in Section 60 (1) CBA 2009 indicates an obligation imposed on the CBM to promote Malaysia as a hub for the Islamic financial sector. Additionally, the CBM is also allowed by the legislation to provide financing ‘for the development and promotion of Malaysia as an international Islamic financial centre.’<sup>584</sup> There is, however, an absence of such a provision indicating the same obligation for the CBM to promote the conventional financial services sector. The only reference to a general provision, which is aimed at the whole financial services sector, is where the

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<sup>583</sup> Section 60 (1) Central Bank Act 2009

<sup>584</sup> Section 60 (2) (b) Central Bank Act 2009

role of the CBM is defined as ‘to promote a sound, progressive and inclusive financial system’.<sup>585</sup>

While this is the case, it can be suggested that the emphasis given to focussing on and developing the status of Malaysia as an international hub for the Islamic financial services sector indicates a lack of equality at the substantive level between the conventional and Islamic financial sectors in Malaysia. Viewed from the conventional financial services perspective, therefore, the lower emphasis on promoting the conventional financial services sector leads the question of whether the conventional financial services sector is less significant in the eyes of the Malaysian regulators.

Nevertheless, as discussed in chapters two and three, the regulatory accommodation for Islamic banks in the UK and Malaysia involves the question of public policy and political economy. For Malaysia, the concepts of ‘New Malays’ (Melayu Baru) and ‘New Economic Policy’ (Dasar Ekonomi Baru) have been the driving factors for the government to focus on developing the Islamic financial sector. Besides this, the Malaysian government would not be exposed to political-societal issues for giving more attention for the development of Islamic finance for the fact that Malaysia is a Muslim majority country. As such, it can be seen that a greater accommodation for Islamic finance is more obvious in Malaysia for there is more political will as opposed to the UK (more of the influencing factors which contribute to the existing regulatory accommodation have been discussed in chapter two). Moreover, in the UK, the question of the cost and benefit of regulations is crucial and thus, the regulation should bring more economic benefit than the cost incurred. While in Malaysia, although the

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<sup>585</sup> Section 5 (f) Central Bank Act 2009



cost and benefit of regulation plays a role in the regulatory decision making, nevertheless, the government's aim to promote the Islamic financial sector appears to be greater than the economic justification for regulating the Islamic financial services.

Now that the regulatory principles and policies have been highlighted, the rest of this chapter analyses the extent to which the Malaysian regulators have enabled a level-playing field in the existing regulatory framework – the same approach is taken as in the previous chapter. The two test questions are:

- (v) Whether Islamic banks in Malaysia are treated equally before the law; and
- (vi) Whether Islamic banks are given a fair opportunity to compete alongside conventional banks.

The next section examines and analyses whether the dual regulatory accommodation reflects the idea of a level-playing field for Islamic banks and conventional banks in Malaysia. The same approach is used to examine the elements of a level-playing field. This approach will examine whether the existing regulatory framework consists of the elements of an ideal law (clarity, certainty, predictability) as well as using the two test questions above (equality before the law and fair opportunity to compete) to analyse the level-playing field in the regulatory framework – at the transactional level and the institutional level. The regulatory framework in the next section is divided into five sub-sections which includes authorisation, Sharia Supervisory Board (SSB), Islamic finance cases before the Malaysian courts, Sharia-compliant liquidity management and taxation.

## **4.2 LEVEL-PLAYING FIELD AND THE REGULATORY ACCOMMODATION FOR ISLAMIC BANKS**

### **(a) AUTHORISATION**

Thus far, there is no evidence to prove that the regulatory framework governing the authorisation of Islamic banks in Malaysia faced substantive issues as opposed to the authorisation process in the UK. As mentioned earlier, fully-fledged Islamic banking and financial institutions in Malaysia are governed by IFSA 2013 and used to be governed by the Islamic Banking Act 1983. Historically, before the legislative enactment of FSA 2013 and IFSA 2013, the conventional financial institutions that operate 'Islamic windows' were allowed to perform not only Islamic banking business but also Islamic financial business. In other words, the absence of a provision in regards to Islamic financial business in IBA 1983 indicates that fully-fledged Islamic banks in Malaysia were only allowed to conduct Islamic banking business. This, therefore, created inequality at the substantive level. The establishment of IFSA 2013 and FSA 2013 has, however, solved the issue.

With regards to the authorisation process, it can be argued that the dual regulatory framework governing both banking sectors in Malaysia represents a more level-playing field as opposed to the UK approach. As has been observed in the previous chapter, Islamic banks had to compromise certain aspects at the substantive level to suit the conventional regulatory framework in the UK, thus creating inequality at the substantive level. On the other hand, the regulatory accommodation for the authorisation of Islamic banks in Malaysia represents formal and substantive equality between the institutions. For instance, IFSA 2013 is applicable to a financial institution

that is carrying on a fully-fledged Islamic banking business, while the authorisation process for a conventional financial institution, which intends to operate 'Islamic windows', is governed by FSA 2013. For a conventional financial institution intending to operate Islamic banking or financial business, therefore, a consultation process must be conducted with the Central Bank of Malaysia.<sup>586</sup> Compliance with the provisions in Parts IV, VI, IX, X and XIII of IFSA 2013 shall be observed by a financial institution wishing to operate a certain type of approved business under 'Islamic windows' operation.<sup>587</sup>

Secondly, conventional financial banks that operate 'Islamic windows' must be a member institution under the Malaysia Deposit Insurance Corporation, (MDIC) also known as Perbadanan Insurans Deposit Malaysia.<sup>588</sup> Notably, MDIC is equivalent to the UK Deposit Guarantee Scheme designed to protect Islamic finance depositors as well as maintaining stability in the financial system and consumer confidence.<sup>589</sup> MDIC is defined as:

'a system established by the Government to protect depositors against the loss of their insured deposits placed with member institutions in the event the member institution fails.'<sup>590</sup>

The level-playing field in the dual regulatory framework can be inferred where an authorisation for establishing an 'Islamic window' by a conventional bank is similar to

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<sup>586</sup> Section 15 of Financial Services Act 2013

<sup>587</sup> Section 15 (2) (a) Financial Services Act 2013

<sup>588</sup> MDIC is governed by Malaysian Deposit Insurance Corporation Act 2005. MDIC is also known as Perbadanan Insurans Deposit Malaysia (PIDM)

<sup>589</sup> MDIC (2013) via <<http://www.pidm.gov.my/>> accessed: 20 December 2013

<sup>590</sup> Ibid.

an authorisation for a fully-fledged Islamic bank. It shall acquire the recommendation from the CBM by virtue of Section 8 IFSA 2013. Accordingly, an Islamic bank must also be a member institution under MDIC. Such procedures represent equality at the formal and substantive level. In this regard, the procedure is generally the same with the UK practice; however, the difference is that separate legislation is applicable in Malaysian practice.

While the general practice is similar, nevertheless, greater equality at the substantive level can be inferred in the Malaysian practice in the case where a bank is in default. Both Islamic and conventional deposits are protected equitably. The regulatory accommodation pertaining to deposit protection provides an opportunity for the Islamic banks to compete alongside the conventional banks - where Islamic deposits are covered separately from conventional deposits.<sup>591</sup>

The level-playing field in the dual regulatory framework shows that the separated funds received from the conventional banks and Islamic banks are grouped separately into the Islamic Deposit Insurance Fund or Conventional Deposit Insurance Fund. Section 55 of the MDIC Act 2011 states that:

All payments made by the Corporation in respect of:

- (a) Islamic deposits and all costs associated therewith shall be made from the Islamic deposit insurance fund; and
- (b) conventional deposits and all costs associated therewith shall be made from the conventional deposit insurance fund.

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<sup>591</sup> Section 47 PIDM Act 2011. Also see, PIDM Deposit Insurance Handbook (2011) via <[http://www.pidm.gov.my/downloads/2011/HandbookDI\\_2011.pdf](http://www.pidm.gov.my/downloads/2011/HandbookDI_2011.pdf)> accessed 20 December 2013

The funds received by depositors are made from these separate channels. The Islamic financial depositors are assured that the funds are not intermingled with conventional funds, hence market confidence is created through this regulatory accommodation. Moreover, MDIC guarantees no transfer of funds from these groups in the case where there is shortage of funds. In the case of Islamic banking depositors, notably, the priority among Islamic depositors and types of Islamic deposits are determined based on the contracts underlying the deposits. For instance, 'non-Mudaraba (non-profit sharing) deposits such as Wadiah deposits have priority over Mudaraba (profit sharing) deposits.'<sup>592</sup> Furthermore, the investments by MDIC through the permitted investment channels are managed in accordance with Sharia principles.<sup>593</sup> In this regard, the Malaysian regulatory framework reflects a more level-playing field as opposed to the UK practice - where the latter does not separate the depositors' funds from the conventional and Islamic financial deposits.

#### **(b) SHARIA SUPERVISORY BOARD (SSB)**

As opposed to the UK practice where there is no regulatory accommodation for Sharia supervision, the regulatory framework governing Sharia supervision for Islamic banks and financial institutions, which also includes banks with Islamic windows, in Malaysia is considered to be well structured. The regulatory accommodation placed the Sharia

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<sup>592</sup> MDIC Annual Report 2005, p.57

<sup>593</sup> MDIC Annual Report 2005 and Section 30 (3) MDIC Act 2011. It is also permitted for the MDIC to borrow from the government if extra funds are needed and in the case of a payout for Islamic depositors, this borrowing will be in compliance with Sharia principles." See, Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking*, (2010), p.199

committee or Sharia Advisory Board as the most influential department for banking and financial institutions carrying out Islamic financial transactions.

One may argue about how Sharia supervision relates to level-playing field regulation. At first glance, the significance of highlighting the regulatory accommodation for Sharia supervision appears not to be closely related to the question of a level-playing field. This is because a glance at this issue does not demonstrate the first and second element of what a level-playing field is (equality before the law and a fair opportunity to compete between conventional and Islamic banks). The supervision of Islamic banks is simply part of the bank's corporate governance due to its Sharia nature and certainly, one may argue that there is no issue of a level-playing field. Such an argument, however, may be right to a certain extent should this issue be viewed at a superficial level.

There is, however, a significant point in highlighting the regulatory accommodation governing Sharia supervision. Sharia supervision is regarded as a significant aspect of an Islamic bank's corporate governance and an appropriate regulation is crucial in ensuring an Islamic bank's competitive position. An appropriate corporate governance regulation that could help to promote a level-playing field for Islamic banks is, therefore, justified for several reasons. Firstly, the purpose of establishing a sound regulatory framework for Sharia supervision or governance is to preserve market confidence in the Islamic financial services industry.<sup>594</sup> Secondly, without proper guidelines for Sharia supervision or a corporate governance framework, Islamic banks could potentially be exposed to several types of risk such as regulatory risk,

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<sup>594</sup> Global Islamic Finance Report 2011, p.217-219

operational risk, the risk of non-Sharia compliance and other types of risks that can be associated with Islamic banks. Thirdly, the existence of these risks could ultimately lead to reputational risk, which eventually may cause the collapse of the Islamic financial sector at a macro level.<sup>595</sup> Fourthly, proper Sharia supervision is needed to monitor the prudential aspect and market discipline for Islamic banks to promote the stability of the Islamic financial sector. Finally, since the Sharia-compliant aspect of the Islamic financial transaction is the crux of Islamic financial services, the establishment of an appropriate regulatory framework is significant to monitor the Islamic nature of the transactions.

The Sharia compliance of a transaction is arguably the unique marketing asset of the entire Islamic financial services sector. Relating the factors above, which are crucial to the survival of the Islamic financial services sector, this leads to an understanding that the first element of a level-playing field (equality before the law) is vital and, therefore, merits further analysis. A sound regulatory framework for Sharia supervision will help to promote the competitiveness of the Islamic financial services sector as the factors listed above are, indeed, significant in distinguishing the Islamic and conventional financial services sectors. In short, it can be suggested that the survival of the Islamic financial services sector, in particular, market confidence depends heavily on whether the regulators provide a sound regulatory accommodation for Sharia governance – on the form and substance of the Islamic banking business – while such a form and substance issue is not required for conventional banking business. Following this, the relation to the second element of a level-playing field (fair opportunity to compete) is also worthy of analysis.

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<sup>595</sup> Ibid., p.219

While the UK's regulatory framework considers Sharia supervision as part of the conventional corporate governance regulation, in Malaysia, the regulation pertaining to Sharia supervision is reflected in a specific provision through the recent amendment of the Central Bank Act 2009 (CBA 2009). CBA 2009 mandated the establishment of the CBM's Sharia Advisory Council (SAC) by virtue of Section 51 of the Act, making the SAC highest authority to be referred to for issues pertaining to Islamic financial business. (Notably, the SAC of the CBM is separate from the SAC of the Securities Commission, which is given the mandate 'to ensure that the running of the Islamic capital market (ICM) complies with Sharia principles' and to advise the SAC on all matters in relation to the development of the ICM.<sup>596</sup>) Part VII of CBA 2009 provides the rulings, which include its appointment, functions and the scope of the jurisdiction of the SAC. The SAC of the CBM is considered as the National Sharia Advisory Council (NSAC), which comprises 11 members appointed by the Yang di-Pertuan Agong<sup>597</sup> on the advice of the Minister after consulting the CBM 'who are qualified in the Sharia or who have knowledge or experience in the Sharia and in banking, finance, law or such other related disciplines.'<sup>598</sup>

The appointment process for an NSAC member is similar to the appointment of a Court judge and this reflects the prestigious status of its members. Arguably, this exclusive appointment indicates that no exclusive appointment is applicable to a conventional counterpart. Of course, this is mainly due to the fact that there is no corporate

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<sup>596</sup> Securities Commission, 'Islamic Capital Market', (2013) via <<http://www.sc.com.my/>> accessed: 9 August 2013

<sup>597</sup> Yang di-Pertuan Agong = King (the)

<sup>598</sup> Section 53 Central Bank Act 2009, See <<http://www.bnm.gov.my/>> accessed: 9 August 2013



committee at the national level to supervise the legitimacy of conventional financial products. Therefore, this surely does not provide a strong justification for the lack of equality at the substantive level between institutions.

Notably, the functions of the NSAC are mainly:-

- (a) to ascertain the Islamic law on any financial matter and issue a ruling upon reference made to it in accordance with this Part (Part VII);
- (b) to advise the Bank on any Sharia issue relating to Islamic financial business, the activities or transactions of the Bank;
- (c) to provide advice to any Islamic financial institution or any other person as may be provided under any written law; and
- (d) such other functions as may be determined by the Bank (CBM).<sup>599</sup>

The functions provided above, therefore, indicates that the function of the NSAC is to advise on the Sharia-compliant aspect of Islamic finance contracts but not to decide whether such contract is valid as that decision is bestowed upon the Civil court.<sup>600</sup> It can, therefore, be suggested that the regulatory accommodation above represents the element of formal equality for all banking and financial institutions in Malaysia, which requires Islamic financial businesses to consult the NSAC for any issues concerning Islamic financial business. The establishment of the NSAC means that there is a specific establishment at the national level for the regulatory decision-making process as opposed to the UK practice where the regulators combine both financial services

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<sup>599</sup> Section 52 of Central Bank Act 2009

<sup>600</sup> Tun Abdul Hamid and Adnan Trakic, 'The Sharia Advisory Council's Role in Resolving Islamic Banking Disputes in Malaysia: A Model to Follow?', (2012), p.8

sector through a single body. This issue has, however, been discussed in the UK chapter.

### **(i) 'Fit and Proper' Criteria**

It was observed earlier that the UK's fit and proper requirement governing Sharia board members is based on the conventional corporate governance guidelines representing a non-specific approach to cater to the Islamic nature of an Islamic bank's corporate governance. In Malaysia, the approach taken by the regulators is similar in regards to the fit and proper criteria. Instead of having dual regulatory guidelines, a single guideline was issued, namely the Fit and Proper Criteria for the Islamic banking and Takaful industry catered for both 'conventional banking and financial institutions' and 'Islamic banking and financial institutions'.<sup>601</sup>

It can be suggested that the applicability of the guidelines for all the banking and financial institutions is the representation of formal equality between all the financial institutions in Malaysia as the guideline is issued in pursuant to IFSA 2013 and FSA 2013.<sup>602</sup> The standard minimum requirements for the fit and proper requirements are: (a) probity, personal integrity and reputation, (b) competency and capability; and (c) financial integrity.<sup>603</sup> Notably, these minimum requirements are the same as listed in Section 60 of FSA 2013 and Section 69 of IFSA 2013. The requirements are applied to persons at the top management level of a financial institution, which includes the directors, members of the Sharia committee, the Chief Executive Officer (CEO) and

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<sup>601</sup> Section 2, 'Fit and Proper' Criteria, (2013) via <<http://www.bnm.gov.my/guidelines>> accessed: 11 August 2013

<sup>602</sup> Section 3, Ibid.

<sup>603</sup> Section 60 Financial Services Act 2013, Section 69 Islamic Financial Services Act 2013

senior officers as well as the company secretary. In fulfilling the probity, personal integrity and reputation criteria, a person must not be disqualified by virtue of the criminal and civil offences provided in the guidelines.<sup>604</sup>

## **(ii) 'Competent' requirement**

Competency and capability entails a person who possesses 'relevant knowledge, experience and ability to understand the technical requirements of the business, the inherent risks and the management process required to perform his role in a key function in the relevant capacity effectively.'<sup>605</sup> Finally, a person with financial integrity is 'a person who manages his own financial affairs properly and prudently.'<sup>606</sup>

While the Fit and Proper guideline consists of general provisions, the details of the criteria are left to the banking and financial institution to provide their own requirements and policies internally.<sup>607</sup> An Islamic bank shall consist of a Sharia committee<sup>608</sup> composed of at least three members; a qualified Sharia committee member is to possess necessary knowledge, expertise or experience in the area of Islamic jurisprudence (Usul-al-Fiqh) or Islamic commercial law (Fiqh al-Muamalat). This rule, however, is flexible in the sense that paper qualifications on the mentioned subjects are not mandatory as long as the candidate possesses the necessary expertise or

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<sup>604</sup> Section 11, 'Fit and Proper' Criteria, (2013) via <<http://www.bnm.gov.my/guidelines>> accessed: 11 August 2013

<sup>605</sup> Section 12, Ibid.

<sup>606</sup> Section 11, Ibid.

<sup>607</sup> Section 7.2, Ibid.

<sup>608</sup> Section 30 IFSA 2013

experience in the subject areas.<sup>609</sup> Furthermore, there is no specific requirement in regards to the number of years required to qualify as an 'experienced' person, thus it is left to the financial institution to decide accordingly.<sup>610</sup> Hence, it can be suggested that this lack of standardisation in terms of the eligibility of Sharia committee members produces lack of equality at the substantive level between institutions, since the regulation is flexible in relation to paper qualifications and years of experience.

Research has shown that the presence of a competent supervisor having accounting or finance experience on an SSB makes a positive and significant impact on the financial performance of an Islamic bank. (Some SSBs may not have enough banking and financial experience).<sup>611</sup> Thus, while the existing regulation is seen to be flexible, the choice of an eligible member in an Islamic bank remains crucial so as to minimise the potential legal risk or operational risk. Additionally, earlier research has also questioned the impact and efficiency of an SSB as a value-creator for Islamic banks.<sup>612</sup> Such question can be supported with existing evidence from Islamic financial cases brought before the court, which highlights the fact that the Sharia-compliant aspects of Islamic financial contracts can be brought into question (This will be discussed further in the next section).

Notably, the CBM has seriously considered the importance of Sharia supervision to ensure the smooth running of the Islamic financial sector thus establishing the NSAC

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<sup>609</sup> 'Bank Negara Malaysia Guidelines on the Governance of Sharia Committee', via <http://www.bnm.gov.my/> accessed: 12 July 2013

<sup>610</sup> Ibid.

<sup>611</sup> Hamadi Matoussi and Rihab Grassa, 'Is Corporate Governance Different for Islamic Banks? A Comparative Analysis between the GCC Context and the SEA Context', (2012), p.11-12

<sup>612</sup> Ibid., p.11

to solve disputes arising at the subordinate level (SSB in an Islamic bank). A good approach can be seen in the standardised framework established for each member of the Sharia committee to serve for a renewable period of two years in order to minimise any conflict of interest.<sup>613</sup> It is also noteworthy that the IFSB has higher expectations (preferable) in terms of the criteria for a Sharia committee member where it states:

“It is reasonable to expect a member of a Sharia board to have strong skills in the philosophy of Islamic law (Usul al-Fiqh), as he or she must know exactly the appropriate Fiqh methodologies for deriving juristic opinions; and good knowledge of written Arabic, as he or she needs to be very conversant with the primary sources of the Sharia.”<sup>614</sup>

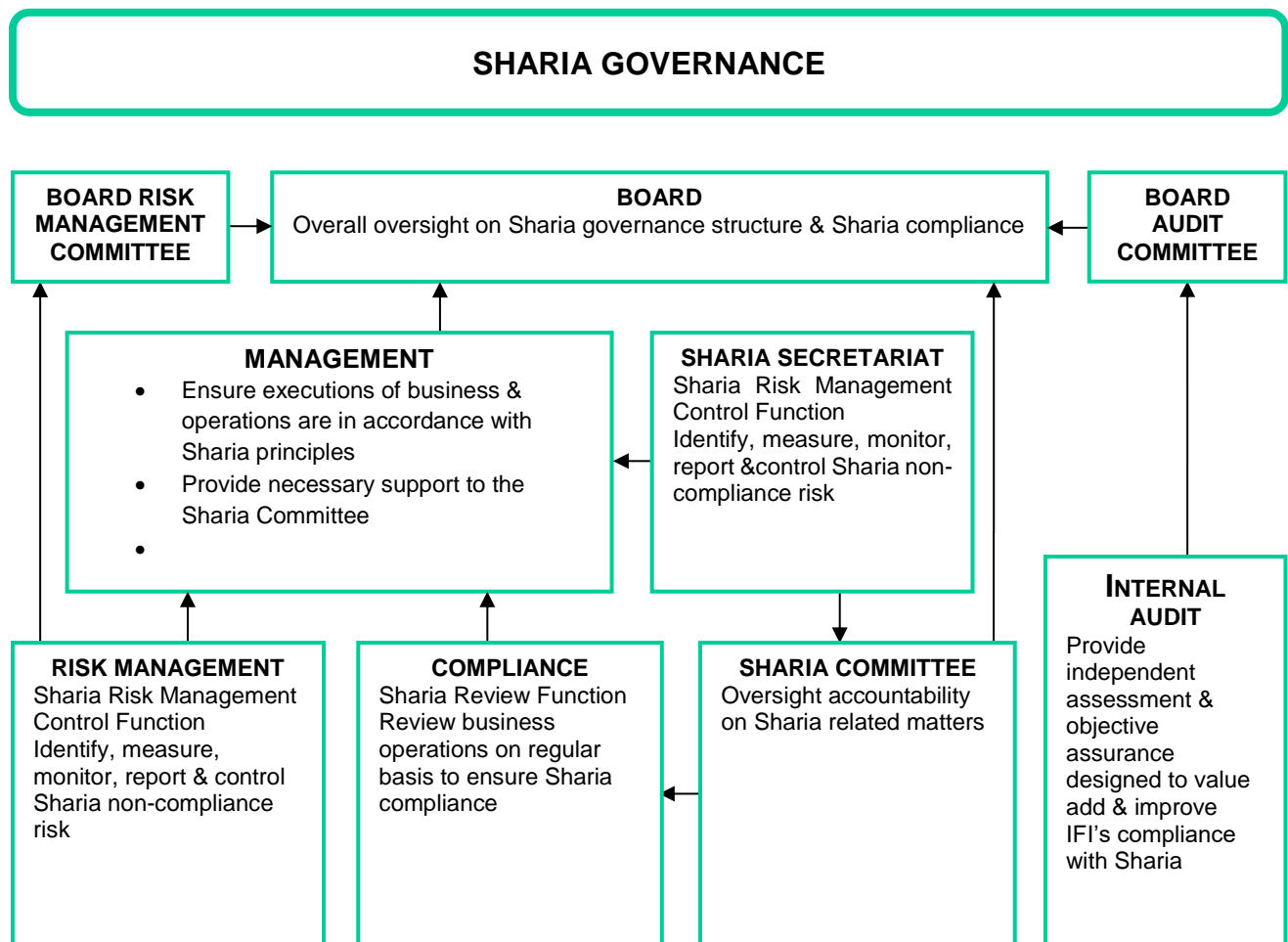
Moreover, the IFSB standards require higher qualifications for one to be a Chairman of a Sharia committee. For instance, the person must have ‘at least three years of experience of making Sharia pronouncements or resolutions or at least four years post-qualification experience in teaching or research in Islamic finance...’<sup>615</sup> These requirements are recommended to all Islamic banking and financial institutions globally. Notably, the Malaysian regulators did not indicate expressly that IFSB requirements should be the preferred guideline for all Islamic banking and financial institutions in Malaysia – similar to the UK practice.

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<sup>613</sup> Supra, Note. 609

<sup>614</sup> Islamic Financial Services Board Guidelines-10, Guiding Principles on Sharia Governance Systems For Institutions Offering Islamic Financial Services, (2009)

<sup>615</sup> Ibid.



Source: Bank Negara Malaysia

The above structure shows the Sharia governance framework, which is applied by the fully-fledged Islamic banks in Malaysia. It shows that a detailed framework has been put in place to ensure that Islamic banking and financial institutions are operating to a standard imposed by the CBM. While the overall structure of the framework is similar to the conventional practice, nevertheless, it provides a specific focus for Islamic banks' corporate governance. Such a model reflects the level-playing field in the regulation as well as reduces legal risk and operational risk. The structure above is, however, not a requirement imposed by the UK regulators. As mentioned in the UK chapter, Sharia supervision is treated in a similar way to conventional corporate

governance practice, hence Islamic banks are given the freedom to operate their own cooperate governance as long as the banks comply with the conventional regulatory framework.

Now that the regulatory framework governing Sharia supervision has been discussed, the next section analyses the regulatory accommodation governing Islamic financial disputes before the Malaysian courts in which regulatory clarity and standardisation will be examined.

### **(c) ISLAMIC FINANCE CASES BEFORE THE MALAYSIAN COURTS**

It can be argued that the application of the formal equality element for Islamic finance litigation in the Malaysian court system is rather unique, because the litigation is conducted within the Civil courts' jurisdiction and not the Sharia courts' jurisdiction. There are two main courts that operate in Malaysia - the Civil courts and the Sharia courts. The jurisdictional power of the Malaysian courts is governed by the Federal Constitution (FC). The courts' scope of jurisdiction are listed in the FC, which states that all matters provided in the Federal List of the FC shall be heard before the Civil courts and matters, which falls under the State List of the FC, will be dealt with by the Sharia courts.<sup>616</sup> This practice has, therefore, led to the understanding that level-playing field regulation for the Islamic financial sector in Malaysia is not entirely within the dual system, because the scope of the jurisdiction for Sharia is limited.

The Civil courts' jurisdiction covers all civil and criminal law matters excluding matters within the jurisdiction of Sharia courts. The Sharia courts' jurisdiction covers only

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<sup>616</sup> Federal Constitution of Malaysia, Ninth Schedule

Islamic law matters that fall within the remit of family law and religious offences<sup>617</sup> and is limited to hearing cases only 'over person professing the religion of Islam.'<sup>618</sup> In other words, since an Islamic banking and financial institution is not considered to be a 'person professing the religion of Islam' – disputes concerning Islamic finance cases in Malaysia are governed by the Civil courts – as indicated earlier. The regulatory framework for disputes in the Islamic financial sector in Malaysia is, therefore, governed by a mixture of civil and Islamic legislation including but not limited to IFSA 2013, CBA 2009, Rules of Court 2012, National Land Code 1965, Civil Law Act 1956, Hire Purchase Act 1967 and Contracts Act 1950.

The level-playing field in the regulatory accommodation governing Islamic finance disputes represents formal equality between the banking and financial institutions; nevertheless, its application in practice is limited to a certain extent. In other words, there are still issues at the substantive level for Islamic banks. This can be shown in two examples. Firstly, while Islamic finance cases in Malaysia are tried before the Muamalat<sup>619</sup> Division of the High Court (the Muamalat Division was created mainly for administrative arrangements) as an additional division to the existing divisions at the High Courts of Kuala Lumpur – such as 'criminal, family and property, commercial, appellate and special powers.'<sup>620</sup> The creation of the Muamalat court is merely to allocate Islamic finance cases to a specific division and not necessarily to decide Sharia issues. This could be inferred in the decided cases hereinafter. It is also worth noting that the Muamalat court is only established in Kuala Lumpur and not in any

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<sup>617</sup> Ibid.

<sup>618</sup> Ibid.

<sup>619</sup> Muamalat = Islamic transaction

<sup>620</sup> Supra, Note. 600, p.11



other states in Malaysia. Tun Hamid and Trakic asserts that ‘at other places, especially where there is only one Judge, all type of cases are registered in the same court and heard by the same Judge.’<sup>621</sup>

Secondly, the application of formal equality is limited to a certain extent depending on the judges’ view of Islamic financial cases. Generally, the Malaysian courts’ judges have viewed Islamic financial contracts as contract law similar to the UK’s judicial practice. For example, in *Bank Islam Malaysia Berhad v. Adnan Omar*<sup>622</sup> the defendant defaulted in the loan facility granted by the plaintiff under a Bai Bithaman Ajil<sup>623</sup> agreement. One of the objections given by the defendant was that the Civil court had no jurisdiction to hear the case by virtue of Article 121A of the Federal Constitution. The provision states that the ‘High Courts and the inferior courts (the Session and the Magistrates courts) shall have no jurisdiction in respect of any matter within the jurisdiction of the Sharia courts.’<sup>624</sup> In this case, N. H Chan J held that a Sharia court has no jurisdiction over Islamic financial cases due to the fact that matters pertaining to banking and finance fall within the Federal List of the FC. As such, only Civil courts have the power to hear Islamic financial cases and not the Sharia courts.

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<sup>621</sup> Ibid.

<sup>622</sup> [1994] 3 CLJ 735

<sup>623</sup> Bai Bithaman Ajil is equivalent to the credit sale under conventional financing. It is inferred that BBA is equivalent to the credit sale under conventional financing and prohibited under the Hanafi, Maliki and Hanbali schools because the aim of this financing structure is based on lending on interest – which is similar to a type of sale known as Bay-Al-Inah. Nevertheless, as argued by Hegazy, ‘many Islamic banks in Malaysia use a special structure of BBA as a legal artifice, *Hila*, to circumvent the prohibition of Riba.’ See, Walid Hegazy, ‘Islamic Finance in Malaysia: A tax perspective’, (2011), p.218-220

<sup>624</sup> Mohd Illiyas Seyed Ibrahim, ‘The Regulatory Framework and Legal Aspects of Islamic Banking and Finance in Malaysia’, in Daud Bakar and Engku Rabiah Adawiah Engku Ali (eds), *Essential Readings in Islamic Finance*, p.277, See, Ninth Schedule, Federal Constitution of Malaysia.

Secondly, as mentioned earlier, the State List of the FC enumerates that Sharia courts shall have jurisdiction only 'over person professing the religion of Islam'. Therefore, as the Plaintiff is a corporation and cannot have a religion, the existing dispute could not be brought to the Sharia court. Moreover, Ranita Hussein JC in a judgement made earlier at the High Court held that parties were *ad idem*<sup>625</sup> in treating the granted amount of RM583,000 as the facility amount given to the defendant by the plaintiff. In particular, the judge held that:

"In the present case there is no question of there being any interest because of the Islamic nature of the loan. The defendant's default is in respect of the instalment payments and this has been duly particularised by the plaintiff."<sup>626</sup>

The Islamic financial dispute in the present case was viewed as merely a breach of contract law. Similarly, in the case of *Bank Kerjasama Rakyat Malaysia Berhad v. Emcee Corporation Sdn. Bhd*<sup>627</sup>, the judge ruled that although the dispute is concerning an Islamic financial contract (Bai Bithaman Ajil contract), the Court viewed that the applicable law and principles are similar to the law and principles of conventional banking. In this case, Abdul Hamid JCA held;

"As was mentioned at the beginning of this judgment the facility is an Islamic banking facility. But that does not mean that the law applicable in this application is different from the law that is applicable if the facility were given under conventional banking. The charge is a charge under the National Land Code. The remedy available and sought is a remedy provided by the National Land Code. The procedure is provided by

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<sup>625</sup> *Ad Idem* = mutual consent

<sup>626</sup> *Bank Islam Malaysia Berhad v. Adnan Bin Omar* [1994] 4 BLJ 372

<sup>627</sup> [2003] 1 CLJ 635

the Code and the Rules of the High Court 1980. The court adjudicating it is the High Court. So, it is the same law that is applicable, the same order that would be, if made, and the same principles that should be applied in deciding the application.”<sup>628</sup>

Based on the above judgment, it can be asserted that Islamic financial disputes in Malaysia are not treated differently from conventional financial disputes in the Civil courts. In another example such as the case of *Tinta Press Sdn.Bhd v. Bank Islam Malaysia Berhad*<sup>629</sup>, the Court viewed the Ijara transaction as merely a conventional leasing transaction dealing with the common law principles on leasing. Similarly, in the case of *Tahan Steel Corporation Sdn Bhd v. Bank Islam* the application of the common law principle of equity was applied by the court.<sup>630</sup>

While generally the judicial practice in Malaysia is similar to the UK, a slightly different approach was taken by the Malaysian regulators with regards to the jurisdictional power of the Court and the Sharia Advisory Council (SAC). A special provision was enacted in the Central Bank Act 2009 that shows that the regulator has made an effort to implement substantive equality for Islamic banks. For example, Section 56 (1) of the Central Bank Act 2009 obliged the Court or Arbitrator to refer to the Sharia Advisory Council rulings when a dispute pertaining to Sharia matters arises in an Islamic financial dispute before the Court or Arbitrator. Section 56 (1) of the Central Bank Act 2009 (CBA 2009) reads:

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<sup>628</sup> Bank Kerjasama Rakyat Malaysia Berhad v. Emcee Corporation Sdn. Bhd [2003] 1 CLJ 635

<sup>629</sup> [1987] 1 CLJ 474

<sup>630</sup> [2004] 6 CLJ 25

(i) Where in any proceedings relating to Islamic financial business before any court or arbitrator any question arises concerning a Sharia matter, the court or the arbitrator, case may be, shall—

- (a) take into consideration any published rulings of the Sharia Advisory Council; or
- (b) refer such question to the Sharia Advisory Council for its ruling.

It can be argued that based on the term 'shall' in the provision above, the Courts are obliged to refer to the SAC rulings should there be any question concerning Sharia matters and the decisions made by the SAC are binding upon the court or arbitrator by virtue of Section 57 of CBA 2009. The latter's section states:

“Any ruling made by the Sharia Advisory Council pursuant to a reference made under this Part shall be binding on the Islamic financial institutions under Section 55 and the court or arbitrator making reference under Section 56.”

It can be inferred that while the regulators' effort is to impose equality at the substantive level by solving Islamic financial disputes at the NSAC, an arising question is to what extent the provision above could be applied by the Civil courts in Malaysia; this is due to the fact that Civil courts in Malaysia are also governed by other civil law legislation. This means that Section 56 of the CBA is rather limited to a certain extent. Moreover, it can also be argued that although some sitting judge may be willing to refer to the SAC for its ruling on Sharia matters and adopt it in the existing case, some judges could take the view that the rulings of the SAC should not overrule the independent powers given to the judiciary. Thus, the judiciary is given full liberty to decide whether the Sharia issues should be brought to the SAC; the Federal Constitution of Malaysia

grants the judiciary an independent power to judge cases without the influence of the executive and the legislature.

This fact can be inferred from a judgment made in *Sugumar Balakrishnan*,<sup>631</sup> where the relationship between the organs of the government was elaborated by Gopal Sri Ram JCA that held:

“The Federal Constitution has entrusted to an independent judiciary the task of interpreting the supreme law and indeed all laws enacted by the legislative arm of the government. Hence, it is to the court that citizens must turn to enforce their rights. It is important to ensure that powers of the judiciary are not usurped by the legislature or the executive. This would maintain the separation of powers which aims to prevent concentration of powers that may increase the likelihood of abuse of powers. The Federal Court also has the inherent jurisdiction under the common law to deal with cases with a view to preventing injustices in limited circumstances. This is in line with Section 3 (1) (a) of the Civil Law Act 1956, which was promulgated in accordance with Cl.(c) of Art.121 (2) of the Constitution which confers the Federal Court such jurisdiction as may be conferred by or under federal law.”<sup>632</sup>

The separation of powers between the executive (Article 39), the legislature (Article 44) and the judiciary (Article 121) are stated in the FC of Malaysia. The judgment made in the above case, therefore, leads to the conclusion that, although the Malaysian regulators have granted special power to the NSAC to decide on Sharia matters, nothing can change the fact that independent power is granted to the judiciary. This means that, legally, the judiciary has the right to refuse to refer issues

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<sup>631</sup> [1976] 2 MLJ 262

<sup>632</sup> MGG Pillai v. Tan Sri Dato' Vincent Tan Chee Yioun [2002] 2 MLJ 673, FC

to the NSAC for its ruling. This further leads to the conclusion that the creation of the separate provision could not deny the absolute power of the provisions of the FC of Malaysia. Ultimately, it can be argued that the level-playing field in the dual regulatory framework has seen a coalition between the existing legislations hence producing a lack of standardisation in the regulatory and judicial practice.

The judgments cited above have shown that in reality, the exclusive power for the NSAC to impose rulings and to be the subject of reference for Islamic financial disputes is rather limited. This can be due to several factors.

Firstly, the sitting judge takes the view that the disputed issue in an Islamic financial case is not considered to be a Sharia issue, because, based on the facts presented by disputing parties, there is no Sharia issue to be tried. The cases are, therefore, decided based on common law principles *per se*. For example, in the case of in the case of *Malayan Banking Bhd v. Marilyn Ho Siok Lin* <sup>633</sup> the common law doctrine of equity was applied. David Wong JC stated that:

“I am fully aware that the BBA documents are drawn up based on Islamic principles and *I am applying the common law principle of equity in construing the same*. This approach is available to me as everyone knows the principle of equity is consistent with Islamic teachings. (emphasis added)”<sup>634</sup>

Next, in the case of *Arab-Malaysian Finance Bhd v. Taman Ihsan Jaya Sdn Bhd & Ors*<sup>635</sup>, Abdul Wahab Patail J held that :-

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<sup>633</sup> [1984] 2 CLJ 23

<sup>634</sup> [2006] 3 CLJ 821

<sup>635</sup> [2008] 5 MLJ 632

“the Civil court’s function, in this case, to render a judicially considered decision before it according to law and not apply Islamic law as if it were Sharia court. Its function is to examine the application of the Islamic concept and to ensure that the transactions in the cases before it do not involve any element not approved in Islam.”

Secondly, the Malaysian courts apply the common law principle of *stare decisis* and the principle of judicial precedent. The *stare decisis* principle or ‘to stand by decided matters’ is the doctrine of precedent, which essentially requires that judges apply the same reasoning to the existing lawsuits as has been used in previous judicial decisions (of the similar kind).<sup>636</sup> Therefore, should the Malaysian judges opt to apply this principle, similar English law cases or earlier cases decided by the Malaysian court, which involve similar issues, would be followed by the sitting judge in the existing case.

Thirdly, there is the application of the civil and common law for the Civil courts in Malaysia. Section 3 of the Civil Law Act 1956 states that the application of English common law and the rules of equity to be applied by the courts in Malaysia and where there are *lacunae* in the law, Section 5 of the Civil Law Act 1956 provide that the English common law shall be referred. In particular, Section 5 of the Civil Law Act 1956 states that:

“In all questions or issues which arise or which have to be decided in the States of Peninsular Malaysia other than Malacca and Penang with respect to the law of partnerships, corporations, banks and banking, principals and agents ... the law to be administered shall be the same as would be administered in England in the like case at the date of the coming into force of this Act.”

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<sup>636</sup> The Longman Dictionary of Law, (2007), p.552

The factors above, therefore, lead to the argument that although Section 56 (1) of the Central Bank Act 2009 as mentioned earlier imposed such an obligation, the obligation remains open to the sitting judge to refer to the SAC rulings. For example, in the case of *Affin Bank Bhd v. Zulkifli Abdullah*<sup>637</sup>, Abdul Wahab Patail J decided that based on the disputed issue of this case, the reference to the SAC was not necessary as there was no question of Sharia law, although this case involved an Islamic financial contract (BBA). Abdul Wahab Patail J held:

“Since the question before the court is the interpretation and application of the terms of the contractual documents between the parties and of the decisions of the courts, *reference of this case to another forum for a decision would be an indefensible abdication of this court of its function and duty to apply established principles to the question before it.* It is not a question of Sharia law. It is the conclusion of this, therefore, that there is no need to refer the question to another forum.” (emphasis added).<sup>638</sup>

As such, it can be viewed that the judgements made by the Malaysian judges reflect the neutral approach in deciding Islamic financial disputes – similar to the practice of the UK’s judiciary. The existing judicial practice shows that Islamic principles are considered, however, it will not turn the Civil court into a Sharia court. This means that although there may be a Sharia-compliance aspect in a disputed case, the practice in the Malaysian judicial system will generally be based on the common law approach and the question of the Sharia-compliant aspect of the contract is left to the judge’s discretion.

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<sup>637</sup> [2006] 1 CLJ 438

<sup>638</sup> Ibid.



The level-playing field in the Malaysian regulatory framework also poses another issue with regards to the scope of the law in resolving Islamic financial disputes. While the Malaysian regulators have enacted separate legislation for the Islamic financial sector, the regulators, however, did not consider further the implication of the provision in the existing legislation (IFSA 2013). In particular, questions arise as to which law should be applied in the case of a conflict of laws. The application of other laws was seemingly solved by Section 279 of IFSA 2013, which states that:

“... but where there is any conflict or inconsistency between the provisions of the Companies Act 1965 and this Act in their respective application to the person or operator, the provisions of this Act shall prevail.”

The above provision indicates that should there be any conflict pertaining to the provisions of the Companies Act 1965, which is inconsistent with the provision of IFSA 2013, the latter’s provision shall prevail. This raises an issue as to whether the conflicts of law are only limited to Companies Act 1965. What about the conflicts of law in other Civil law legislation or common law principles? Hence the question arises as to whether the regulators applied the principle of *expressio unius est exclusio alterius* (the express mention of one thing implies the exclusion of another). In this regard, the existing regulatory framework has led to the issue of conflicts of law between the IFSA 2013 provision and other common law legislation.

While formal equality appears to exist through the dual regulatory framework, the existing regulatory framework contains lack of regulatory clarity and has hence created inconsistency in the application of the law. Some authors have argued that legislative amendments should be made to the existing civil law legislation if the regulators aim

to avoid conflicts of law and to resolve the issue of compatibility of laws. It has been suggested that Section 5 of the Civil Law Act 1956 should be amended by adding: '(in the absence of any written law, the applicable law is the English law) not including Islamic finance and any trading under Islamic finance.'<sup>639</sup> It has also been proposed that 'the area of conflict between the Islamic Banking Act and other laws which influence Islamic banks, such as National Land Code, Hire Purchase Act and Companies Act need to be resolved'<sup>640</sup> and it has also been proposed that 'Malaysia needs to have Islamic Hire Purchase Act, Islamic Contract Act as well as Islamic Companies Act in order to ensure that the practices are in accordance with Syara' (Sharia).'<sup>641</sup> Indeed, it can be asserted that such proposals may potentially solve the issue of conflicts of law and could possibly promote equality at the substantive level between the institutions. Nevertheless, the extent to which the legislative amendment would be useful is questionable since the majority of issues disputed in Islamic financial cases are not related to the Sharia-compliant aspects of the contract.

As has been argued earlier, most of the cases stated above were disputes related to the issue of payment default and little dispute were raised concerning Sharia. Furthermore, the initial concern of the parties in the above cases was not related to the principles of Sharia law. The question of Sharia law only arises when the parties defaulted in payment. This is similar to the judgment held by Morison J in *Beximco's* case as cited in an earlier chapter. It can, therefore, be argued that the introduction

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<sup>639</sup> Hakimah Yaacob, 'The New Central Bank of Malaysia Act 2009 (Act 701): Enhancing the Integrity and Role of the Sharia Advisory Council (SAC) in Islamic Finance', (2010), p.14

<sup>640</sup> Norhashimah Yassin, 'Legal Aspects of Islamic Banking: Malaysian Experience', (2003), p.18

<sup>641</sup> Mustafa 'Affi, 'Enhancing the Effectiveness of the Legal Infrastructure: A Study on Legal issues and Other Challenges of Islamic Banking and Finance in Malaysia', p.12

of new legislation 'to ensure that the practices are in accordance with Syara' (Sharia)' is not practical. Furthermore, the question of the Sharia compliant aspects of a transaction would not be affected without having specific legislation. Moreover, procedurally, an Islamic bank should have sought approval from their SSB for their Sharia-compliant transaction. It can, therefore, be argued that enacting new legislation would not provide a strong basis to ensure that the transaction in each individual case could be said to be Sharia compliant.

In furtherance to the above, the issue arises as to what type of *madhab* (Islamic school of thought) should be chosen for the legislative enactment in the case involving international Islamic financial transactions. One may suggest that should Malaysia aim to be a global hub for Islamic finance, a universal legislation should be made available to tailor all types of Islamic financial disputes from all schools of thought. Nevertheless, such an approach is rather unfeasible. The suggestion to have the regulatory amendments especially in regards to the conflicts of law, however, could be the preferred approach as it would provide more regulatory clarity in the law and promote substantive equality at the institutional level.

In sum, the dual regulatory framework has shown that the reference to the SAC rulings in the Central Bank Act 2009 is limited – where it covers only the reference to its rulings on Sharia disputes *per se*, but ultimately the SAC judgment is not regarded as a binding decision by the Civil courts in Malaysia. For instance, Abdul Hamid Mohamad JCA stated that:

“the ruling of the SAC is not binding on the Court in any case. It is not necessary to refer to the SAC of BNM, as such reference is discretionary, its rulings are not binding,

and the issue in the particular case was not one of Sharia compliance of the BBA facility but the interpretation of its terms, which the judges of the Civil court would interpret on the basis of the principles of common law.”<sup>642</sup>

In *Mohamad Alias Ibrahim v. RHB Bank Bhd & Anor*<sup>643</sup>, Mohd Zawawi Salleh J held:

“For questions concerning a Sharia matter, the Civil court is bound to take into consideration any published rulings of the SAC or refer such questions to the SAC for its ruling and any such ruling made shall be binding on the court. The issue of whether the facility is Sharia compliant or not is only one of the issues to be decided by the court. And although the ascertainment of Islamic law as made by the SAC will be binding on the court as per the Impugned Provisions, it will be up to the court to apply the ascertained law to the facts of the case. The court still has to decide the ultimate issues which have been pleaded. Consequently, the final decision remains with the court.”

The learned judge further held:

“The SAC did not perform a judicial or quasi-judicial function. Its function was confined to the ascertainment of Islamic law on a financial matter. The court still had to decide the ultimate issues which had been pleaded.”<sup>644</sup>

It is asserted that the regulators’ vast effort to introduce substantive equality between institutions produces conflicts of law. It represents the collision between the power given to NSAC and the independent power given to the court. The judgments made by the Civil court judges above thus demonstrates that the test to be applied by the

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<sup>642</sup> Supra, Note. 639, p.8

<sup>643</sup> [2011] 4 CLJ 654

<sup>644</sup> Ibid.

Civil court in deciding Islamic financial disputes is by questioning whether the Islamic financing facilities are approved by the basic principles of Islam and must be universally acceptable by all madhabs. As held by Abdul Wahab Patail J:

“The Islamic financing facilities are presented as Islamic to Muslims of all madhabs. The facilities do not say they are offered only to Muslims of a certain madhabs, for example Shafie. If a facility is to be offered as Islamic to Muslims generally, regardless of their madhab, then there is no element not approved by the Religion of Islam under the interpretation of any of the recognised madhabs. That it is acceptable to one madhab is not sufficient to say it is acceptable in the Religion of Islam when it is not acceptable by the other madhabs.”<sup>645</sup>

The example justifies the approach of the civil court judges who consider Islamic financial contracts on the common law principles, hence resulting in a reluctance to refer cases to the NSAC. Moreover, the conflict of law also poses problems with regards to the application of madhabs. For example, the Islamic financial contract of Bai Bithaman Ajil is only approved by Malaysian regulators, which adopt the Shafie school of thought, but not in other jurisdictions.<sup>646</sup>

In sum, it can be asserted that in this respect, the approach by the Malaysian judges shares similarities with the approach taken by UK judges. The dual regulatory framework, which seems to treat the Islamic and conventional financial sectors equally, is not being fully implemented with regards to Islamic financial disputes before the Malaysian courts. There is still lack of regulatory clarity and standardisation in the dual regulatory framework.

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<sup>645</sup> Arab-Malaysian Finance Bhd v. Taman Ihsan Jaya Sdn Bhd & Ors [2008] 5 MLJ 632

<sup>646</sup> See, Walid Hegazy, ‘Islamic Finance in Malaysia: A tax perspective’, (2011), p.220

The next section discusses the liquid management regulation in the Malaysian dual regulatory framework. Similar to the UK chapter, the section examines whether the regulator has enabled a level-playing field in the dual regulatory framework and whether there are problems relating to a level-playing field in the framework.

#### **(d) SHARIA-COMPLIANT LIQUIDITY MANAGEMENT REGULATION**

As has been mentioned in the previous chapter, Islamic banks require an appropriate liquidity management framework to help them remain liquid in the financial market.

The establishment of the Islamic Inter-Bank Money Market (IIMM) in Malaysia is a platform for Islamic banks and banks participating in the Islamic Banking Scheme (IBS) to manage their liquidity.<sup>647</sup> This means that the IIMM is open not only to Islamic banks, but also conventional banks. The IIMM was established in 1994, ten years after the establishment of the first Islamic bank in Malaysia, Bank Islam Malaysia Berhad (BIMB).<sup>648</sup> Prior to the establishment of the IIMM, BIMB had to rely on the Government Investment Certificate (GIC) to manage its liquidity. Historically, the GIC which was acquired from the Central Bank of Malaysia (CBM) was the only option for BIMB. GICs were bought by BIMB when they had a liquidity surplus and resold to CBM when they were in need of liquidity. In light of the fact that the Islamic banking sector was developing rapidly, the GIC option was considered inadequate and there was no secondary market available for Islamic banks and Islamic windows.<sup>649</sup> Due to this

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<sup>647</sup> Banks under IBS are 'Islamic windows' banks

<sup>648</sup> 'Islamic banking' via <<http://www.bnm.gov.my/>> accessed: 23 May 2015

<sup>649</sup> Obiyatolla Batcha, 'The Islamic Interbank Money Market and a Dual Banking System: The Malaysian Experience', (2008), p. 5

problem, the IIMM was created as a platform for interbank trading of Islamic financial instruments and Mudaraba Interbank Instruments (MII).<sup>650</sup> MII is a concept where 'deficit Islamic banking institution ('investee bank') can obtain investment from a surplus Islamic banking institution ('investor bank') based on Mudaraba (profit-sharing).'<sup>651</sup> The profit-sharing ratio is negotiable among the parties and the investor bank will only know its actual return plus profits (if any) made by the investee bank at the end of the investment period.<sup>652</sup>

The creation of IIMM represents an opportunity for all the banking and financial institutions to compete fairly. As opposed to the UK practice, where there is an absence of a platform that functions similar to the IIMM, hence causing a lack of opportunity for Islamic banks to compete against their conventional counterparts. The fact that the Islamic financial sector in the UK is rather small means, however, that an interbank money market for Islamic banks could be a difficult approach. There is, however, an absence of empirical evidence to prove such an argument. As has been mentioned earlier, the IIMM in Malaysia was created when the Islamic banking sector was relatively new. Thus, it can be suggested that the Malaysian practice could be an example for the UK to assist liquidity management for Islamic banks.

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<sup>650</sup> 'Islamic banking' via <<http://www.bnm.gov.my/>> accessed: 23 May 2015

<sup>651</sup> 'Islamic Interbank', Ibid.

<sup>652</sup> Apart from the GIC and MII, other liquidity instruments for all Islamic banks and participating banks are Sukuk Bank Negara Malaysia Ijara (SBNMI), Wadiah Acceptance (WA), Bank Negara Monetary Notes-i, Sell and Buy-Back Agreement, Cagamas Mudaraba Bonds, When Issue (WI) Islamic Negotiable Instruments of Deposit and Islamic Debt Certificate (INNID and NIDC), Islamic Private Debt Securities, and Ar-Rahnu Agreement. See, <<http://iimm.bnm.gov.my/>> accessed: 23 May 2015

Notably, during the IIMM's earliest years, there was no model of liquidity management for Islamic banks.<sup>653</sup> Bankers at that time were more familiar with the conventional banking framework, hence the operation of IIMM replicates its conventional counterpart. Liquidity instruments available for Islamic banks, therefore, are generally 'Islamised' versions of conventional liquidity instruments such as Islamic Bankers Acceptance, Malaysian Islamic Treasury Bills and Negotiable Islamic Instruments of Deposit (NIID).<sup>654</sup> Additionally, the pricing of these instruments generally follows the conventional practice of discounting. The key difference, however, is that 'the prevailing interest rate of appropriate term to maturity is used in conventional pricing whereas the profit-rate or mark-up rate is used in discounting Islamic instruments.'<sup>655</sup>

The formal equality in the dual regulatory framework shows that conventional banks can invest in the IIMM, while Islamic banks are not allowed to invest in the conventional interbank money market. This is due to the Sharia-compliant nature of Islamic banks hence investing in a conventional interbank money market is not allowed. While in principle the creation of the IIMM is seen to represent a level-playing field for Islamic banks and appears to accommodate the inherent nature of Islamic finance, however, in practice, issues arise with regards to the liquidity investments in the existing dual regulatory framework. Several types of risks are identified in the existing IIMM. For instance, Islamic banks in the IIMM are exposed to interest-rate risk similar to conventional banks where in theory Islamic banks should not be exposed to such risk

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<sup>653</sup> Supra, Note. 649, p.11

<sup>654</sup> Ibid., See, via <<http://iimm.bnm.gov.my/>> accessed: 23 May 2015

<sup>655</sup> Supra, Note. 649, p.11



due to their interest-free nature. Earlier research has examined the correlation between rates of return for Islamic banks and the three- month interest rates of conventional banks. It has been found that ‘there is extensive interest rate exposure for the Islamic banking sector.’ It was also found that:

“Deposit formation across both banking sectors was strongly linked. The free flow of funds between the two banking sectors and the large pool of non-Islamic clients that Islamic banks have, would ensure arbitrage flows if rates were different between the sectors. As a result, not only were the rates similar across the banking sectors, they were also very closely related.”<sup>656</sup>

Apart from the interest-rate and arbitrage risks, another type of risk, Sharia-compliance risk arises and this could not be overlooked. The fact that the IIMM operates with both banking sectors and that the dual banking system is strongly interconnected, Islamic banking activities could not be completely detached from the conventional banking sector. It has been argued that:

“Since the IIMM replicates the conventional system, both in terms of trading processes and instruments, any yield differences between the IIMM and the rest of the system would constitute a pure arbitrage opportunity. As such, a well-functioning IIMM operating within a dual system would inevitably have yields/profit rates that closely resemble the yields and interest rates in the conventional system. Such synchronicity however, has a huge implication about the relevance of interest rate risk to a supposedly ‘*interest-free*’ market.”<sup>657</sup>

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<sup>656</sup> Ibid.,p.12-13

<sup>657</sup> Ibid., p.15

Due to the above issue, the Islamic banking sector is exposed to Sharia risk and hence raises the question of the real difference between the Islamic and the conventional banking practice. The IIMM has undoubtedly provided the opportunity for both banking sectors to manage their liquidity in the inter-bank money market. Despite this, Sharia-compliance risk arises from the replication of the conventional banking practice. To support the view that Islamic banks and the conventional banks in the inter-bank money market are operating with a very strong linkage, empirical research has been conducted on the daily quoted yields in the Malaysian IIMM and the conventional money market. A total of four interbank yields with the daily quotes for the (i) overnight, (ii) one week, (iii) one month and (iv) three month interbank transactions were tested in a research exercise using an economic theory called the Granger Causality Test. Over the study period of 10 years, the results of this test have found very strong one-way causation from the conventional and Islamic banking sector. It also appears that there is a strong correlation across both sectors for both interest/profit rates and deposits.<sup>658</sup> As a result, the users of the IIMM would face the same interest rate risk as the conventional players do.<sup>659</sup>

This means that in the dual regulatory framework, which is supposed to serve the unique features of Islamic banks and treat them on a level-playing field, interest rate risk still exists, while theoretically Islamic banks should be interest free.<sup>660</sup> Furthermore, it has also been found that in the Malaysian dual regulatory framework

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<sup>658</sup>Ibid., p.19

<sup>659</sup>Ibid.

<sup>660</sup>Ibid.

the 'interest rate differentials between the Islamic and conventional money markets create arbitrage opportunity for the conventional financial institution, leaving Islamic financial institution at a disadvantage since these institutions are limited to transacting only in the Islamic financial market.'<sup>661</sup> Such a finding has therefore led to the argument that Islamic banks remain at a disadvantage in a financial system that operates in parallel thus questioning the efficiency of having the dual regulatory framework.

In sum, the fact that the Islamic banking sector is operating in the dominantly conventional sector shows that Islamic banks cannot be completely detached from interest-rate risk and Sharia-compliance risk. It is rather difficult for Islamic banks to avoid such a situation, which is similar to the UK Islamic banking and financial sector. For the UK Islamic banks, however, the difference is that these banks are facing a lack of liquid assets options that they can hold. On the contrary, in Malaysia, Islamic banks do not have the issue of liquid assets options but rather the issue pertains to the Sharia compliance of their liquidity management via the IIMM. While the IIMM is seen to be able to provide a better level-playing field for Islamic banks to compete with conventional banks, the formal equality in the dual regulatory framework shows that substantive issues still exist. Although a separate platform such as IIMM is available, the Sharia compliance aspect of Islamic banks is questionable and to a certain extent is compromised.

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<sup>661</sup> Salina Kassim, 'The Information Content of the Islamic Inter-bank Money Market Rate in Malaysia', (2008), p.310

We now turn to the next section, which highlights the taxation framework for the Islamic financial sector in Malaysia. As noted in the UK chapter, the topic of taxation is not directly related to the topic of regulation. However, Islamic banks are affected by the regulatory accommodation on taxation for their retail mortgage products. Hence, the analysis of the regulatory accommodation pertaining to taxation is relevant. It does reflect the regulator's treatment of the Islamic financial sector and the extent of a level-playing field in the dual regulatory framework.

#### **(e) TAXATION - PRINCIPLES AND POLICIES**

There is an absence of explicit principles and policies for taxation adopted by the Malaysian government – other than aiming to have a taxation system that achieves a more equitable distribution of the tax burden and generating revenue for the government.<sup>662</sup> It has been argued that 'until the mid-sixties, it was difficult to cite any evidence to support the contention that tax policy in Malaysia is used to achieve any objective other than to raise revenue.'<sup>663</sup> The possible rationalisation on the taxation objective since the 1970s was:

- (a) to promote investment and stimulate industrial development.
- (b) to promote national saving and improve the free flow of goods leaving the country through harmonisation of tax rates between Peninsular Malaysia, Sabah and Sarawak.
- (c) to promote a more equitable distribution of income and wealth through a somewhat progressive Income tax structure and Real Property Gains Tax.

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<sup>662</sup> Barjoyai Badai, *Malaysian Tax Policy: Applied General Equilibrium Analysis*, (1993), p.27

<sup>663</sup> Ibid.

(d) to alleviate the burden of inflation especially on the lower income groups.<sup>664</sup>

The taxation framework in Malaysia shows that there was no separate legislation governing Islamic financial instruments in Malaysia – similar to the UK practice. While the UK established its Tax Technical Working Group, Malaysia established a Working Committee on tax neutrality in 2003 to approve a scheme of financing based on Sharia principles, which is eligible for tax neutrality treatment. The tax neutrality committee comprises of senior officials from the Ministry of Finance (MOF), Inland Revenue Board (IRB) and the CBM officers.<sup>665</sup> The tax neutrality committee was established with the aim of creating a level-playing field between both financial services sectors, ensuring that Islamic financial transactions, which produce the same economic impact as conventional financial transactions, receive equivalent tax treatment.<sup>666</sup>

Several legislative amendments were made in order to accommodate the distinctive nature of Islamic financial instruments. In Malaysia, the main legislation, which involved a regulatory accommodation for the taxation of Islamic financial instruments, comprises the Income Tax Act 1967, Stamp Duty Act 1949 and Real Property Gain Tax Act 1976.

The Malaysian government has provided several tax incentives to promote the development of Islamic finance. The tax incentives were given to Islamic banking and financial institutions licensed under IFSA 2013 such as tax exemption of 100% from

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<sup>664</sup> Ibid.

<sup>665</sup> BNM Annual Report 2004 via <<http://www.bnm.gov.my>> accessed: 9 July 2013

<sup>666</sup> BNM Financial Stability Report 2012, p.82

Year of Assessment (YA) 2007 to YA 2016 “on income derived from Islamic banking business conducted in international currencies.”<sup>667</sup> Secondly, ‘20% stamp duty remission on Islamic finance instruments as approved by the Central Bank of Malaysia and the Securities Commission from 2 September 2006 to 31 December 2015.’<sup>668</sup> Exemption on the Real Property Gains Tax was also given on ‘chargeable gains accrued on the disposal of any chargeable assets under Islamic principles.’<sup>669</sup> This also applies to the ‘disposal of any chargeable assets in relation to the Sukuk al Ijara of Bank Negara Malaysia which are issued or to be issued by BNM Sukuk Berhad.’<sup>670</sup> The tax incentives in Malaysia, arguably, are considerably more than those provided by the UK regulators and promote a level-playing field for Islamic banks to further develop.

#### **(i) Income Tax**

There is no definition for the term ‘income’ in the Income Tax Act 1967 (ITA 1967). It can, therefore, be argued that the term income is to be derived from ‘the ordinary meaning of the term.’<sup>671</sup> The tax levied under ITA 1967 is construed as:

‘income tax...charged for each year of assessment upon the income of any person accruing in or derived from Malaysia or received in Malaysia from outside Malaysia.’<sup>672</sup>

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<sup>667</sup> MIA, ‘Tax Treatment on Islamic Finance Malaysia’ via <<http://www.mia.org.my/>> accessed: 25 November 2013

<sup>668</sup> MIFC, ‘Incentives for Islamic Banking’ via <<http://www.mifc.com/>> accessed: 15 November 2013

<sup>669</sup> Supra, Note. 667

<sup>670</sup> Ibid.

<sup>671</sup> Ibid.

<sup>672</sup> Section 3 of the ITA 1967

In order to accommodate the taxation treatment for Islamic financial products in Malaysia, there were several legislative amendments to ITA 1967 in 2003.<sup>673</sup> The added provisions intended to place the taxation for Islamic financial transactions on a level-playing field with the taxation imposed on conventional financial transactions. For instance, Section 2 (7) of ITA 1967 states that:

“Any reference in this Act to interest shall apply, *mutatis mutandis*, to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of Sharia.”

The effect of the provision above represents the application of the element of formal equality and substantive equality in ITA 1967. Prior to the legislative amendment of Section 2 (7) ITA 1967, the taxes on Islamic financial transactions were based on the reference to the generic provision in ITA 1967. Section 2 (7) ITA 1967 provides that the taxes levied for Islamic financial transactions are treated equally with conventional transactions. It can be inferred that the reference to ‘interest’ (which refers to conventional transactions) in the provision above is taxed equally to ‘gains or profits’ received from the income of Sharia-compliant transactions. In other words, all accrued tax on ‘interest’ mentioned in the legislation is applicable to ‘profits’ arising from Islamic financial transactions.

The regulatory practice for taxation in Malaysia is similar to the UK, in principle and in practice. In other words, the economic substance for Islamic financial transactions is based on conventional practice. The regulatory accommodation, therefore, sees the

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<sup>673</sup> Akta Cukai Pendapatan 1967 via <<http://www.hasil.gov.my/>> accessed: 9 July 2013> accessed: 1 May 2014

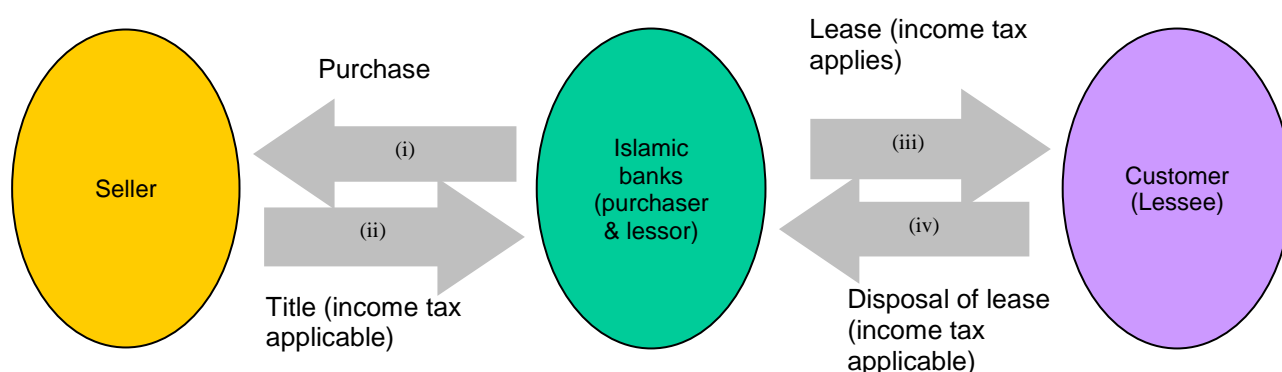
profits arising from the Islamic financial transactions such as Bai Bithaman Ajil<sup>674</sup>, Murabaha, Istisna', or Ijara taxed in a similar way to tax levied on conventional financial transactions. In regards to the disposal of an asset or a leased Islamic asset, however, such transactions are given tax neutrality as long as the scheme is in accordance with Sharia principles. In particular, Section 2 (8) ITA 1967 reads:

“Subject to subsection (7), any reference in this Act to the disposal of an asset or a lease shall exclude any disposal of an asset or lease by or to a person pursuant to a scheme of financing approved by the Central Bank or the Securities Commission or the Labuan Offshore Financial Services Authority as a scheme which is in accordance with the principles of Sharia where such disposal is strictly required for the purpose of complying with those principles but which will not be required in any other schemes of financing.”

The diagram below provides an illustration of the taxation in operation in the case of Ijara before and after the legislative amendments.

### **Ijara transaction**

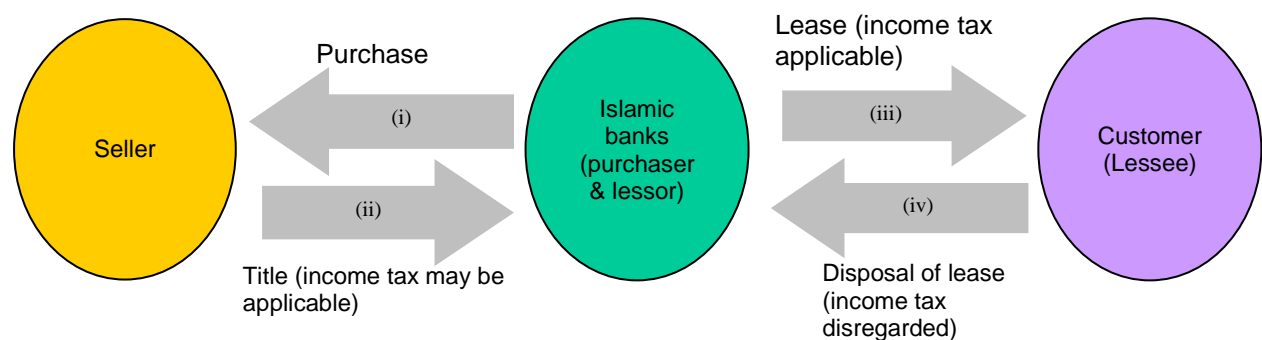
#### **(a) Before the legislative amendments**



<sup>674</sup> Bai Bithaman Ajil – See, Glossary.



## (b) After the legislative amendments



Source: Author's own

Based on the above diagram, the tax neutrality given upon the disposal of the asset or a lease represents equality at the substantive level between all the financial institutions. It can be inferred that the legislative amendment promotes fair competition between the Islamic and conventional financial transactions. Such a practice is therefore similar to the UK practice.

## (ii) Real Property Gains Tax (RPGT)

RPGT is 'charged on gains arising from the disposal of real property, which is defined as any land situated in Malaysia and any interest, option or other right in or over such land. RPGT is also charged on the disposal of shares in a real property company.'<sup>675</sup>

The Real Property Gains Tax Act 1976 (RPGT 1976) is another piece of taxation legislation, which provides a regulatory accommodation for the taxation on Islamic

<sup>675</sup> RPGT and Exemptions via <<http://www.mia.org.my/>> accessed: 28 May 2015

financial transactions. Tax under RPGT 1976 applies to 'gains accruing on the disposal of any real property' or 'the disposal of shares in real property companies.'<sup>676</sup>

In placing the taxation for Islamic financial transactions equally, legislative amendments to the RPGT 1976 were made. The insertion of Paragraph 3 (g) to Schedule 2 of the Act exempts:

"the disposal of an asset by a person to an Islamic Bank under a scheme where that person (customer) is financed by such bank in accordance with the Sharia' and; 'where such disposal will not be required for conventional financing schemes.'<sup>677</sup>

Moreover, RPGT 1976 also gives exemption in regards to 'chargeable gains accrued on the disposal of any chargeable assets. In particular: (a) to or in favour of a special purpose vehicle; or (b) in connection with the repurchase of the chargeable assets, to or in favour of the person from whom those assets were acquired. (exempted for securitisation transaction).'<sup>678</sup> For example, the RPGT 1976 exempts the disposal of any chargeable assets in relation to the *Sukuk al Ijara* of the Central Bank of Malaysia (CBM), which are issued or to be issued by the CBM.

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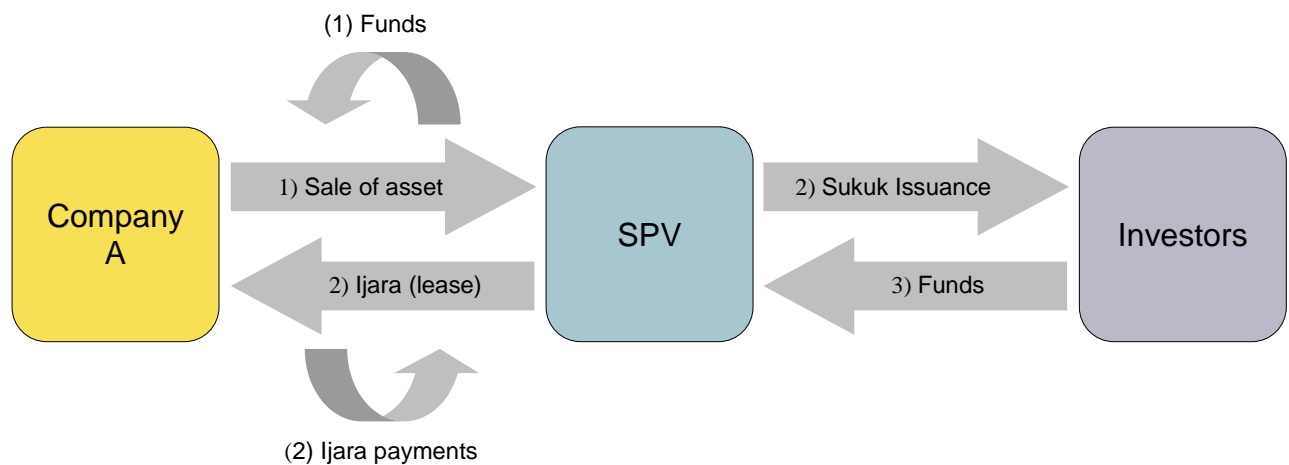
<sup>676</sup> RPGT Act 1976

<sup>677</sup> Malaysian Institute of Accountants, 'Tax Treatment' via <<http://www.mia.org.my/>> accessed: 25 November 2013

<sup>678</sup> Securities Commission, 'Special Incentives Bond Market', via <<http://www.sc.com.my/general-section/special-incentives/bond-market/>> accessed: 25 November 2013

An example of tax neutrality for Sukuk al-Ijara is provided below:-

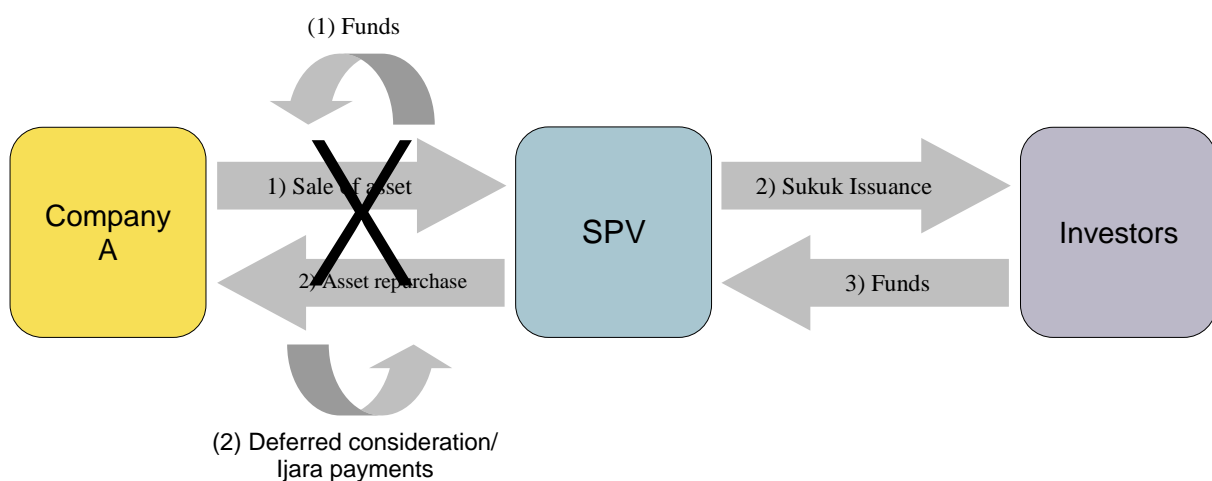
**(a) Before legislative amendment**



(1) Sukuk is issued based on the asset being sold to the Special Purpose Vehicle (SPV) and the latter will lease back to the owner.

(2) The underlying nature of Ijara requires the asset to be leased back hence tax is acquired at this stage of transaction which is not existed in the conventional system.

**(b) After legislative amendment**



Source: Pricewaterhouse Coopers(PWC)

(1) Tax neutrality applied at the place marked due to the additional underlying transaction of *Sukuk Al Ijara* with the condition that Sukuk product is approved by the CBM, Securities Commission or Labuan Financial Services Authority.<sup>679</sup>

(2) Tax neutrality is applied at the place marked (1) and (2) due to the additional underlying transaction of *Sukuk Al Ijara* with the condition that the Sukuk product is approved by the CBM, Securities Commission or Labuan Financial Services Authority.<sup>680</sup> Such a tax-neutral policy is seen as enabling a level-playing field between Islamic banks and its conventional counterparts.

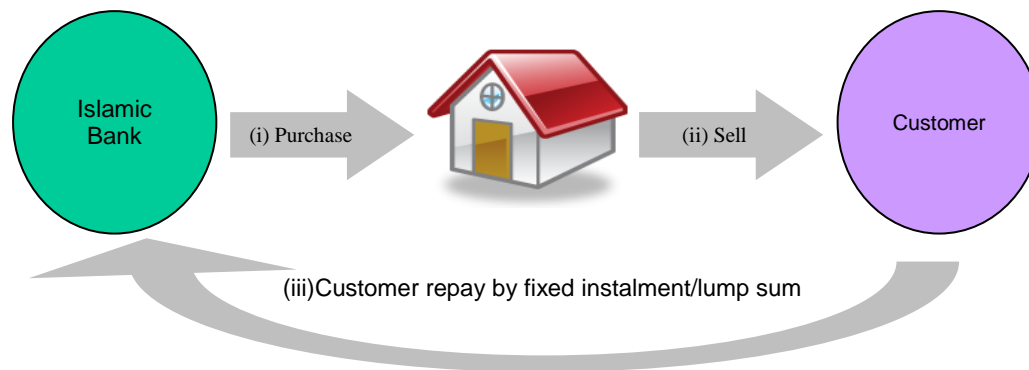
While Paragraph 3 (g) to Schedule 2 of the RPGT Act 1976 exempts the gains from the disposal of real property by the customer to an Islamic banking or financial institution, an arising issue is whether the disposal of the property from an Islamic banking or financial institution to the customer in a contract such as Bai Bithaman Ajil (BBA) (a contract of double sale) is exempted from the RPGT. This is because there is an absence of provision in the legislation to clarify this issue. Before proceeding further, below is a diagram of a BBA transaction:

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<sup>679</sup> Pricewaterhouse Coopers, 'Common Cross Border Taxation Issues on Islamic Finance', (2012), p. 9

<sup>680</sup> Ibid., p.8

### Bai Bithaman Ajil (BBA) Transaction



Source: Author's own

- (i) The Islamic bank purchased the property on behalf of the customer for the original price of RM 500,000.
- (ii) The property is sold to the customer on a mark-up (profit) basis. For instance, RM 600,000.
- (iii) The customer repays the purchase of the property by instalment/lump sum over a pre-agreed period. Tax under RPGT is incurred at the disposal stage. The profit made by the Islamic bank is considered to be appropriately taxed under ITA 1967 as 'business income'.<sup>681</sup>

The nature of the BBA contract entails a deferred payment sale under which the financier sells a product or equipment to one of its customers for a deferred price (which is often higher than the market price) – that is to be paid in the future on an instalment basis or as a lump sum. It has been argued that 'the difference in price between the two sale contracts (representing the bank's profits) should be taxed under the ITA 1967 as business income and should not be subject to RPGT.' Moreover, the

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<sup>681</sup> Ibid.

BBA transaction is argued to be similar to a charge or mortgage.<sup>682</sup> Paragraph 3 (g) of Schedule 2 of the RPGT Act 1976 states that:

“there is an exemption from the disposal of chargeable asset pursuant to a scheme of financing approved by the Central Bank, Labuan Financial Services Authority, Malaysian Co-operation Societies Commission or the SC as a scheme which is in accordance with the principles of Sharia.”

Indeed, some concerns arise from the fact that profits are taxed under Section 4 (a) of ITA 1967 as business income and are not subject to RPGT at the disposal stage of the property. The absence of an express provision pertaining to the issue of RPGT in relation to the BBA financial contract exposes a lack of fair competition with the conventional financial product because the latter is less costly than an Islamic financial contract of BBA.

### **(iii) Stamp Duty Tax**

Stamp duty is a tax levied on legal, commercial and financial instruments specified in the First Schedule of the Stamp Duty Act 1949 (SD 1949). In promoting the usage of Islamic financial instruments, Malaysian regulators have made Stamp Duty exemptions under the Stamp Duty (Exemption) Orders 2000, 2002 and 2004.

In 2000, for instance, an exemption from stamp duty is granted on all instruments that involve ‘the Asset Sale Agreement or the Asset Purchase Agreement executed between a customer and a bank made under the principles of Sharia law for the purpose of renewing any Islamic overdraft financing facility with the condition that the

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<sup>682</sup> Ibid.

Islamic overdraft financing facility have been duly stamped.’<sup>683</sup> In another example, Stamp Duty (Exemption) (No.3) Order 2004 provides exemption to all types of financial instruments, conventional or Islamic, relating to the ‘purchase of property for the purpose of lease back under the principles of the Sharia or under a principle sale and purchase agreement by which the financier assumes the contractual obligation of customer.’<sup>684</sup> This legislative amendment was in force in 2003. Such regulatory accommodations demonstrate that the element of formal and substantive equality between institutions and transactions are applied by the Malaysian regulators. Moreover, it can be inferred that the clarity in the existing law promotes the usage of Islamic financial transactions in the country as well as fair competition between the two types of financial services.

In 2002, legislative amendments were made to produce fair treatment for all banking and financial institutions. In particular, tax exemption on stamp duty for the issuance of credit cards is granted by the Malaysian regulator. This reflects formal and substantive equality at the institutional and transactional level. Under Stamp duty (Exemption) (No.38) Order 2002, the Order provides:

“the exemption of stamp duty on all instruments of the Bai Inah Sale Agreement or the Bai Inah Purchase Agreement executed between a customer and a financial institution made under the principles of the Sharia law for the purpose of the issuance of credit cards.

For the purpose of this Order:

‘a financial institution’ means any financial institution licensed under:

(i) the Banking and Financial Institutions Act, 1989;

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<sup>683</sup> Malaysian Institute of Accountants, Tax Treatment, Stamp Duty (Exemption) (No.9) Order 2000

<sup>684</sup> Malaysian Institute of Accountants, Tax Treatment, Stamp Duty (Exemption) (No.3) Order 2003

- (ii) the Islamic Banking Act 1983;
  - (iii) development financial institutions supervised under Section 2 of the Development Financial Act 2002; or
- any institution approved by Bank Negara Malaysia.”

From the above regulatory accommodation, it can be suggested that the stamp duty taxation regulation governing Islamic financial transactions provides a fair opportunity for the Islamic financial and conventional financial sectors to compete. Moreover, the fact that the calculation of Stamp duty is imposed on *ad valorem*<sup>685</sup> rates for conventional and Islamic financial transactions represents equal treatment at the formal and substantive level.

### **4.3 CONCLUSION**

This chapter has discussed the regulatory framework for Islamic banks in Malaysia and analysed the level-playing field in the dual regulatory framework. From the analysis above, it can be concluded that the dual regulatory framework governing Islamic and conventional banks in Malaysia represents a clear effort by the government and the regulators to promote a level-playing field between both banking sectors. While both countries have the idea of treating all banking and financial services institutions on a level-playing field, a different approach in the regulatory accommodation for Islamic banks in the UK and Malaysia has been adopted. The UK regulatory accommodation for Islamic banks is seen to have a reactive approach, whereas the Malaysian practice is a more proactive approach. A number of similarities, however, were identified in the regulatory accommodation of both

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<sup>685</sup> *Ad Valorem* – according to the value of the property



countries as well as in practice. These include the regulatory accommodation on taxation and judicial interpretation / treatment on Islamic financial cases.

In the existing dual regulatory framework, the regulation pertaining to authorisation of Islamic banks is seen as providing a fairer system for the banks. The deposit insurance scheme under MDIC which separates the conventional and Islamic pooled funds promotes transparency, market confidence and Sharia-compliance of investment. This approach is, however, not yet being implemented in the UK. With regards to Sharia supervision, the specific regulations on 'Fit and Competent' requirement were made to tailor to the nature of Islamic banking operation. It can be inferred that the specific requirements that were established could help Islamic banks to operate in sound corporate governance. Such requirements for Islamic banks' corporate governance are regarded as crucial to minimise the operational risk and legal risk. Such a framework is also not being implemented in the UK. As mentioned in the previous chapter, the 'Fit and Proper' requirement in the UK is made to all banks and there is no additional requirement which suits the nature of Islamic banks' nature.

With regards to the Islamic financial disputes before the Malaysian courts, the dual regulatory framework is rather unique. It has been shown earlier that Islamic banks are governed by a separate regulatory accommodation. In principle, the NSAC is given the liberty to decide on disputes governing Islamic banks but the Malaysian courts are reluctant to admit such empowerment given by the CBA 2009 as the practice of the English common law is favoured. The judicial decision to decide on the prevailing law is very much depend on the judges' discretion. The question on conflicts of law is also another issue at the substantive level. In reality, the reference to the NSAC rulings by

the Malaysian courts is therefore limited. Such a reality therefore creates a lack of standardisation in the Malaysian judiciary system and leads to regulatory uncertainty pertaining to the Islamic financial disputes. While in form, the dual regulatory framework represents a contrasting approach with the UK regulatory framework, in reality, the approach to deal with the Islamic financial cases is the same. Nevertheless, the Malaysian regulatory framework is a step ahead than the UK with regards to the NSAC. There has been an attempt by the Islamic financial sector in the UK to establish an NSAC, however, thus far there has not been any news to confirm its establishment.

In respect of the legal accommodation for Sharia-compliant liquidity management regulation, the separate legal accommodation for Islamic banks in the interbank money market has, in form, shown a level-playing field. Nevertheless, there is interest-rate risk, arbitrage risk and Sharia-compliance risk in the IIMM that result from the mixed investment by conventional banks. Such a problem is seen to be slightly different than the problems of Islamic banks in the UK. As mentioned earlier, the fact that there is limited interbank investment for Islamic banks in the UK, the banks have been suffering from liquidity risk. Both situations have therefore led to the conclusion that further improvements toward a level-playing field can be made. Specifically, in the UK, the limited Sharia compliant liquid asset investments for Islamic banks has exposed the banks to liquidity risk, whereas the separate regulatory accommodation for Islamic banks in Malaysia has provided better liquidity management alternatives for Islamic banks but questions remain over whether the overall outcome is Sharia-compliant in nature. With respect to regulatory accommodation in the area of taxation, it can be inferred that there is a level-playing field for Islamic banks to compete fairly with the conventional banks – similar to the UK practice.

The Malaysian regulators' focus is geared more toward providing a dual regulatory framework for every aspect contained in the conventional regulatory framework. Less substantive compromises are, therefore, observed in the Malaysian regulatory framework. On the other hand, the UK's single regulatory framework for all banking and financial services institutions has resulted in more substantive compromises for Islamic banks while meeting formal equality requirements, thereby leading to a lack of opportunity to compete. While it can be inferred that the dual-regulatory framework provides a better level-playing field, it must be said that the regulators have not enabled a complete level-playing field due to the fact that there is still substantive compromises that has to be made by Islamic banks. Hence, if a complete level-playing field cannot be achieved and there are substantive issues that require certain compromises on the part of Islamic banks, both in single or dual regulatory frameworks, the question is whether there should be more regulation for Islamic banks? As the comparisons on the regulatory accommodation for Islamic banks in the UK and Malaysia have been highlighted and analysed, the next section examines the rationale of regulating Islamic banks and question whether Islamic banks should be given more regulation.

## **CHAPTER FIVE: LEVEL-PLAYING FIELD AND THE IMPACT OF REGULATIONS FOR ISLAMIC BANKS**

### **5.1 INTRODUCTION**

### **5.2 LEVEL-PLAYING FIELD REGULATIONS AND THE IMPACT OF REGULATIONS FOR ISLAMIC BANKS**

#### **5.2.1 CIRCUMSTANCES WHERE REGULATIONS HAVE CHANGED ISLAMIC BANKS**

- (i) Capital Certainty Requirement**
- (ii) Sukuk**
- (iii) Taxation**
- (iv) Sharia-compliant Liquid Assets**

#### **5.2.2 CIRCUMSTANCES WHERE NO REGULATION HAS CHANGED FOR ISLAMIC BANKS AND NO IMPACT TO LEVEL-PLAYING FIELD**

- (i) Sharia Supervision**
- (ii) Islamic Finance before the English courts**

#### **5.2.3 CIRCUMSTANCE WHERE NO REGULATION HAS CHANGED FOR ISLAMIC BANKS AND LEVEL-PLAYING FIELD REGULATIONS LESS EFFECTIVE**

- (i) Diminishing Musharaka Home Purchase Plan**

### **5.3 CONCLUSION**

## 5.1 INTRODUCTION

The preceding chapters have examined the regulatory accommodation for Islamic banks in the UK and Malaysia and the extent of which the regulators have enabled level-playing field regulations for Islamic banks. It was found that the UK and Malaysian approaches to accommodate Islamic banks in their regulatory frameworks differ although the regulators of both states have always believed that Islamic banks should be treated on a level-playing field basis. As the earlier chapters have argued, however, despite the regulators' desire to create a level-playing field between Islamic and conventional banks, the concept of level-playing field regulations has never been clear. In other words, the concept of level-playing field regulations was never at the forefront of the regulators' minds when drawing up regulations for Islamic banks. As a result, in some cases level-playing field regulations may even be ineffective, while in other cases it may be effective.

This chapter examines the extent to which the existing regulatory accommodation fits with the concept of level-playing field regulations. This chapter proceeds by considering examples, which give rise to three criteria: (i) under the level-playing field regulations, specific regulatory accommodations have changed for Islamic banks resulting in an effective level-playing field, (ii) no regulations have changed for Islamic banks resulting in no impact on the level-playing field, (iii) no regulations have changed for Islamic banking resulting in less effective level-playing-field regulations.

Note that in this chapter, heavy reference is made to the UK practice. As the previous chapters have shown, the regulations for Islamic banks in the UK are based on the

conventional regulatory framework. There are, therefore, more issues are found within UK practice. Reference to Malaysian practice is made when relevant. This is due to the fact that in light of the dual regulatory framework, there are regulatory accommodations for almost every aspect of Islamic banking operations and therefore, fewer issues arise. The final section contains the conclusions.

## **5.2 LEVEL-PLAYING FIELD AND THE IMPACT OF REGULATIONS FOR ISLAMIC BANKS**

### ***5.2.1 Circumstances where regulations have changed Islamic banks – effective level-playing field***

This section provides three examples where regulations have changed for Islamic banks and resulted in an effective level-playing field. These are: capital certainty requirements, regulations on Sukuk and regulations on taxation.

#### **(i) Capital Certainty Requirement**

In Chapter 3, it was mentioned that the regulation under the Regulated Activities Order (RAO) obliged banking institutions including Islamic banks to have capital certainty. As has been discussed earlier, the capital certainty requirement is contradictory to the original practice of Islamic banks which rely on PLS modes, therefore, the profit stabilisation reserve (PSR) has been established for Islamic banks to guarantee the deposit repayment for the depositors.<sup>686</sup> In this regard, the regulatory accommodation has allowed Islamic banks to operate on a level-playing

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<sup>686</sup> As mentioned in chapter 3, PSR is aimed to smooth the volatility in the profit payments that are provided by the bank.

field with their conventional counterparts, although such accommodation is conflicting with profit-loss-sharing principles (as argued earlier, there are substantive compromises on the part of Islamic banks). The regulatory accommodation is seen to fit with the objective of banking regulation, which is mainly to protect bank depositors. Therefore, while such regulatory accommodation which is viewed earlier to be conflicting with PLS principles, it may have changed the original nature of Islamic banking. It is arguably for a positive purpose - to protect the depositors.

## **(ii) Sukuk**

For Islamic investment banks, the changes to tax laws certainly aided the development of the Sukuk market where, as a consequence, they are able to replicate the treasury operations of their conventional counterparts.<sup>687</sup> Without the changes in the tax laws, issuing Sukuk would not have been feasible because of the prohibitively high costs of taxation. Islamic investment banks would not, therefore, have been able to adequately manage their short-term liquidity because, unlike conventional financial institutions, Islamic investment banks are prohibited from investing in interest-bearing conventional treasury securities (e.g. bond instruments).

The legislative amendments in the UK were explicitly designed for the issuance of Sukuk that have economic equivalence to debt, not economic equivalence to equity. [This can also be observed from the terminology chosen by the UK tax authorities whereby the type of Sukuk receiving these taxable benefits comes under the definition of an alternative type of 'bond' (i.e. Alternative Finance Investment Bond)]. The result

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<sup>687</sup> HM Treasury, 'Government Sterling Sukuk Issuance: A consultation', ( November 2007), p.8

of this is that – in order to benefit from the favourable tax environment – Sukuk have been structured in such a way that they are no longer ‘asset-backed’, but rather, they are designed to replicate the structure of a conventional bond. Such structures have come to be known as ‘asset-based’ Sukuk.

### Sukuk al-Ijara

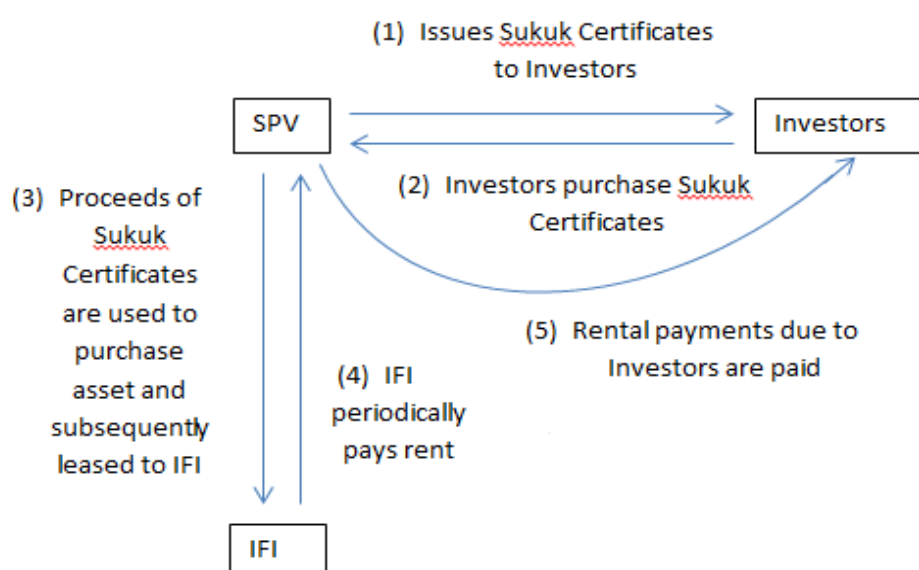


Diagram 1

Source: Author's own

As can be observed from the Sukuk al-Ijara structure above, the proceeds collected from the investors is used to purchase an asset and the investors become owners of the asset. Income (in this case, rental payments from the lease) is ultimately derived from the use of the asset. Furthermore, at maturity, the asset can then be sold to another party and the purchase price would be distributed to the investors according to their share in the Sukuk. Essentially, this sale price is not to be pre-determined and fixed, but rather the price would be agreed at the end of the lease and should reflect market conditions prevailing at that time.



Following from this example, it should be clear that in the case of Sukuk the income stream is derived from the cash-flow generated by use of the asset<sup>688</sup>. Sukuk are, therefore, distinct from bonds, which, by contrast, have their income stream secured by a pre-agreed interest-payments schedule, which involves no asset. By definition, Sukuk are 'asset-backed' equity investments, whereas bonds are designed as 'asset-less' debt instruments. Rather than allowing Sukuk investors to hold an equity stake in the asset, 'asset-based' Sukuk are structured so that the title of the asset is never transferred to the investors. Rather, the 'asset-based' Sukuk involves a purchase undertaking in the form of a unilateral promise (*w'ad*) by the obligor to pay an amount equal to the principal. Moreover, the 'asset-based' Sukuk is structured so that the 'sale' of the underlying asset at maturity can only be made to the originator and not any third party. As a result, the obligor retains a hold on the asset while the principal amount paid at maturity is fixed and guaranteed.

Therefore, there is no true sale or use of an asset but rather income is generated through the transfer of financial rights via debt obligations<sup>689</sup>. Thus, the economic characteristics of the 'asset-based' Sukuk are identical to a debt-based conventional bond. As stated earlier, however, the key feature of genuine Sukuk is that income is to be derived through the performance of the underlying asset. Despite this, from an investor's perspective, the risk and return of the 'asset-based' Sukuk is based on the

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<sup>688</sup> Jhordy Kashoogie Nazar, 'Regulatory and Financial Implications of Sukuk's Legal Challenges for Sustainable Sukuk Development in Islamic Capital Market', (2011), *8th International Conference on Islamic Economics and Finance Research Paper*, p.5

<sup>689</sup> Razi Pahlavi Abdul Aziz and Anne-Sophie Gintzburger, 'Equity-Based, Asset-Based and Asset-Backed Transactional Structures', (2009), p.276

creditworthiness of the obligor to pay the promised amount and, consequently, the risk and return have no relation to the economic performance of the asset.

Therefore, the regulatory amendments that have successfully created a level-playing field between Sukuk and the bond market have inadvertently created a conflict with the Sukuk market and the objectives of Shariah and Islamic finance. The level-playing field encouraged the development of the Sukuk market into an alternative bond market with a debt-based, fixed-return structure; whereas the objective of Sharia is to promote Sukuk as an equity investment instrument where investors own and derive their returns from an underlying asset.

### **(iii) Taxation**

In regards to taxation, the UK's regulatory authorities have made several legislative changes in the Finance Acts.<sup>690</sup> The legislative changes are made to accommodate the issues on double-taxation, in particular, the Stamp Duty Land Tax (SDLT) accrued on Islamic mortgages – as opposed to the conventional mortgages where there is no issue of double-taxation. The existing law has, therefore, demonstrated that the regulators have enabled level-playing field regulations between Islamic banking mortgages and conventional banking mortgages.

### **(iv) Sharia-compliant Liquid Assets**

In the third chapter, it was highlighted that the recent regulatory accommodation which enables Islamic banks to purchase a lower asset quality has indeed changed liquidity management for Islamic banks to a better level. The regulations have to

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<sup>690</sup> Finance Acts 2003,2005,2007

some extent created a better future for the sustainability of Islamic banks. One may argue, however, that the level-playing field regulations for Islamic banks (when they can purchase a lower quality of asset) can cause a lack of level-playing field on the part of the conventional banks.

### ***5.2.2 Circumstances where no regulations have changed for Islamic banks – no impact to level-playing field***

This section highlights the examples of where no conventional regulations have changed for Islamic banks giving rise to no impact to the level-playing field. These are: Sharia supervision and Islamic financial disputes before the English courts.

#### **(i) Sharia supervision**

As mentioned in the earlier chapter, there is an absence of regulation in regards to the Sharia supervision process in the UK. The absence of regulation is an indication that the regulatory authorities have enabled level-playing field regulations in relation to all financial services in the UK. It can be argued that the absence of regulation for the Sharia scholar or Sharia advisor of an Islamic bank does not have any impact on the concept of creating level-playing field regulations. Moreover, there is no reported data which shows that the absence of regulation on the competency of Sharia scholars would affect the consumers' confidence that leads to a lack of fair competition.

## **(ii) Islamic finance disputes before the English courts**

With regards to the settlement of Islamic financial disputes before the English courts, it is argued that the adoption of the English common law for these disputes could not possibly have any impact on achieving the objective of a level-playing field.

### ***5.2.3 Circumstance where no regulation has changed for Islamic banks –the level-playing field regulations less effective***

This section describes an example where no regulations have changed for Islamic banks and the level-playing field regulation is seen to be less effective.

## **(i) Diminishing Musharaka HPP**

As discussed in the previous chapter on the regulatory framework in the UK, it was observed that a Diminishing Musharaka (DM) model is used to offer Home Purchase Plan (HPP) products to customers as an alternative to conventional home mortgage financing. Because conventional financing arrangements are based on debt, they are intrinsically distinct from the application of DM, which is intended to be based on equity.

According to the ideals of Islamic finance, DM should operate on the basis that ownership of an asset/property is shared (i.e. between an Islamic bank and a client) and, subsequently, one party (i.e. the client) purchases shares of the asset/property from the other party (i.e. the Islamic bank) until all the shares have been purchased and one party (i.e. the client) becomes the sole owner<sup>691</sup>. In practice, however, Islamic

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<sup>691</sup> Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, (2002), p. 57

banks have chosen to incorporate a number of arrangements in addition to the DM agreement, such as an Ijarah (i.e. leasing) contract, which generates rental payments (akin to interest payments).<sup>692</sup> Although such arrangements are permissible according to Sharia when each contract is viewed in isolation, the final structure of the HPP product is such that it no longer operates on an equity basis but rather it is structured to largely to mimic the debt-based conventional financing arrangements.<sup>693</sup>

The UK regulators effectively encouraged this distortion of the DM HPP by amending tax laws, which ensured that DM transactions in Islamic finance were treated the same as conventional loan financing arrangements. In this regard, Her Majesty Revenue and Customs (HMRC) explained the new treatment of DM transactions:

“a customer and a financial institution contribute to jointly acquire an asset. The customer makes a series of capital payments to the financial institution to acquire that institution’s interest in the asset. The customer makes other payments, a ‘return’ to the institution in addition to the amount paid to acquire the institution’s interest - these other payments represent an amount equivalent to the commercial rate of interest on a conventional loan... under the new rules from 22 March 2006 the ‘return’ is taxed as if it were interest.”<sup>694</sup>

Based on the above regulatory treatment, the level-playing field regulations encouraged the development of a DM HPP model that goes contrary to the inherent nature of Islamic finance; a model based on debt and a cash-flow that mimics interest

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<sup>692</sup> Financial Conduct Authority Handbook, ‘PERG 14: Guidance on Home Reversion and Home Purchase Plans’ via <[www.handbook.fca.org.uk](http://www.handbook.fca.org.uk)> accessed: 1 September 2015

<sup>693</sup> Ibid.

<sup>694</sup> HMRC, ‘The Benefits Code: Beneficial Loans: Alternative Finance Arrangements; Islamic Finance’, via <<http://www.hmrc.gov.uk/manuals/eimanual/eim26515.htm>> accessed: 6 August 2015

payments. The regulatory amendments have not, therefore, been sufficient to create an environment that enables the full application of DM based on equity-based ownership of a property. Furthermore, repeated bank failures have pushed regulators towards discouraging retail banks from undertaking direct equity investments. For example, the approach of the Prudential Regulation Authority (PRA), which is responsible for supervising Islamic banks in the UK, can further discourage Islamic banks from partaking in equity-based Musharaka transactions. The PRA publish in their Approach to Banking Supervision that,

“The PRA examines the threats to the viability of a firm’s business model... The analysis includes an assessment of where and how a firm makes money, the risks it takes in so doing, and how it funds itself.”<sup>695</sup>

In the absence of any regulatory accommodation to enable Islamic banks to offer equity-based HPP products, the underlying substance of HPP products offered by Islamic banks are no different to debt-based conventional financing arrangements. As a result, the essential elements of a DM transaction, such as assuming risks relating to the asset are not satisfied. In this regard, Ka & Ng state:

“the form and substance of Islamic products must be consistent with each other. Nevertheless, the form of partnership here does not serve the substance of financing. As an unequal playing field will be created, effect is given to the form over substance... Here, an economic benefit shapes the legal landscape, and not vice versa.”<sup>696</sup>

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<sup>695</sup> Bank of England, ‘The Prudential Regulatory Authority’s Approach to Banking Supervision’, (June, 2014), p.17

<sup>696</sup> Adam Ng Boon Ka, (2009) ‘Shari’ah and Legal Issues of Musharakah Mutanaqisah’, *NewHorizon*, Issue 173, p.47

Following this, it is apparent that better regulations are needed to enable a DM HPP product that is true in both its legal form and economic substance according to the objectives of Sharia and Islamic finance. Moreover, it can be argued that due to the discouragement of equity investments, retail banks' participation in various other applications of Musharaka is also negatively affected. This further impedes the opportunity for Islamic retail banks to realise the higher objectives of Islamic finance. On the other hand, one may also argue that while the regulatory framework may impede Islamic banks in achieving the objectives of Sharia, in reality; Islamic banks are probably not ready to accept losses under the PLS modes. While Islamic banks have to make substantive compromises to fit into the existing regulatory accommodation, it can be argued that the regulatory framework for Islamic banks with regards to HPP is indeed promoting a level-playing field.

### **5.3 CONCLUSION**

The previous two chapters have shown that UK and Malaysian regulators have not enabled the level-playing field regulations in totality within the conventional regulatory framework (UK) and dual regulatory framework (Malaysia). It was also found that Islamic banks in the UK were governed by simple regulations under the conventional regulatory framework, whereas in Malaysia, more regulation is established for Islamic banks within their dual regulatory framework. In the system of both countries, the level-playing field regulations have led to the establishment of several criteria and have resulted in notable impacts on Islamic banks. The first section of this chapter has categorised three notable results arising from the three criteria. – (i) specific regulatory accommodations for Islamic banks have produced effective level-playing field regulations (ii) the absence of specific regulations for Islamic banks has resulted in

there being no impact on level-playing-field regulations (iii) the absence of specific regulation has prevented Islamic banks from fulfilling Sharia requirements, making level-playing-field regulation less effective.

Under the first criteria, it is found that the regulations for Islamic banks with regards to capital certainty requirements, Sukuk and the abolition of double taxation have resulted in an effective level-playing field. Under the second criteria, it is found that the absence of regulations pertaining to Sharia supervision of Islamic banks and the approach of the regulators pertaining to Islamic financial disputes (where the common law system applied) do not produce any impact on the level-playing field. With regards to the third criteria, Islamic financial contracts such as Diminishing Musharaka Home Purchase Plan (HPP) have shown that the absence of regulations does not allow Islamic banks to fulfil their Sharia ideals, hence making the level-playing-field regulations less effective (in the sense that equality at the substantive level is compromised). It was, however, mentioned in this chapter, that PLS modes of transaction have only been practiced on a small scale. One may argue, therefore, that the existing level-playing-field regulations do not change any aspect of Islamic banking practice. On another hand, one may also argue that the absence of regulations has not allowed Islamic banks to realise their theoretical nature (the PLS modes). Finally, it can also be inferred that from the analysis of the impact of level-playing field regulations and the Islamic finance ideals, the regulators have not enabled absolutely level-playing-field regulations for Islamic banks and ultimately, the concept of the level-playing-field regulations for Islamic banks are not workable.



## **CHAPTER SIX: CONCLUSION**

### **6.1 INTRODUCTION**

### **6.2 RESEARCH FINDINGS**

### **6.3 RESEARCH LIMITATIONS**

### **6.4 FUTURE RESEARCH RECOMMENDATIONS**

### **6.5 FINAL REMARKS**

### **6.1 INTRODUCTION**

This research was principally designed to analyse the level-playing field regulations governing Islamic banks in the UK and Malaysia. The main objective of this research was to examine the extent to which the regulatory accommodation governing Islamic banks in the UK and Malaysia reflects the notion of level-playing field regulations. This research was also conducted to analyse the areas within the level-playing field regulations which exposes Islamic banks to risks. In light of these objectives, several other subsidiary objectives that were aimed by this research which includes: analysing whether the regulators have enabled the level-playing field regulations in the UK and Malaysia, whether the level-playing field regulations is indeed a useful concept, analysing the extent to which the regulators have reconciled the level-playing field regulations within the existing complexities and uncertainties in the financial system as well as examines the need of more banking regulations for Islamic banks in light of the objectives of banking regulations.

In achieving the principal and subsidiary objectives, this thesis has developed test questions which allows the research to reach its findings which comprises of (i) whether Islamic banks are treated equally before the law (formal equality and

substantive equality) and (ii) whether Islamic banks are given a fair opportunity to compete alongside the conventional banks. In reaching the ultimate conclusion of this chapter, an extended question was used apart from the two test questions above. As mentioned in chapter one of this research (Section 1.6), the test question of whether the playing field is level, is by asking when the level-playing field is seen to be distorted (in this regard, whether the outcome depicts an obvious negative outcome and not a mere negative outcome).

This research is believed to be the first of its kind in the subject of Islamic banking for three main reasons. Firstly, it has been as argued in the first chapter that while there are number of literatures which have suggested that Islamic banks should be treated on a level-playing field and the regulators are expected to provide the level-playing field regulations, nevertheless, there is no literature which has identified the elements that can be constituted as level-playing field regulations. Secondly, there is an absence of extensive research which has talked about the challenges, realities, and the objective of banking regulations which is seen to coincide with the notion of level-playing field regulations. Thirdly, this research has provided an analysis of these criteria using the theory as well as the comparative law method. To the best of my knowledge, there is no literature which has made an analysis of the level-playing field regulations by using comparative law methodology.

## **6.2 RESEARCH FINDINGS**

This research has set out that the regulatory architecture for level-playing field regulations governing Islamic banks between Malaysia and the UK differs where the former established dual-regulatory framework whereas the latter's approach is treating

all the banking institutions in the single framework (conventional). Returning to the questions posed in this research, the following paragraphs provide the findings that can be drawn from the present research:

This research has found that generally, the UK approach with regards to the level-playing field regulations is more reactive as opposed to the Malaysian approach which is more proactive. It can be inferred that in term of success in providing the level-playing field regulation, the analysis drawn from this research has shown that Malaysian approach is more successful than the UK approach as there is less substantive compromises on the part of Islamic banks to serve the element of formal equality. On the other hand, the UK conventional regulatory framework has led Islamic banks to have more substantive compromises. Despite this outcome, this research does not suggest that the Malaysian model should be followed by the UK regulators.

One of the more significant findings to emerge from this study is that the regulators in the UK and Malaysia have not enabled the level-playing field regulations in totality for Islamic banks (in totality in the sense that the idea of level-playing field should represent fairness as a whole within the financial sector, and not in some aspect of the regulations). While on the one hand, some regulatory accommodation is seen to reflect that there is a level-playing field, however, in most cases level-playing field regulations has not been effective. These arguments can be supported with the implications provided in the following paragraphs on the impacts of the level-playing field regulations. The results of investigating the level-playing field regulations show that there are three notable impacts deriving from the legal accommodations to Islamic

banks.<sup>697</sup> These are: positive impact, negative impact (in the sense that level-playing field is less effective), neutral impact. We now begin with the UK level-playing field regulations.

In the UK, the finding suggests that the positive impact of the level-playing field regulations can be inferred from the regulatory accommodation on Sukuk, the regulatory decision making process, taxation, Sharia compliant liquid assets regulations and capital certainty requirements. The Sukuk listing requirement (if it is a public debt) has resulted to regulatory standardisation and transparency in the level-playing field regulations. It is also found that this regulation could minimise regulatory arbitrage.

For taxation, the regulatory accommodation that abolished the double taxation also creates a positive impact of level-playing field regulations. The recent regulatory accommodation on Sharia-compliant liquid assets regulation has enabled a positive impact of level-playing field regulations on the part of Islamic banks, however, it was argued in chapter three that this regulatory accommodation may be regarded as lack of level-playing field on the part of the conventional banks due to the fact that Islamic banks can purchase lower quality of assets. In other words, from the perspective of conventional banks, it can be argued that the latter is disadvantaged for there is inequality at the substantive level when Islamic banks are given the privilege to

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<sup>697</sup> Note that the findings provided in this section can arguably be said to be similar with the discussion in chapter five, however, the emphasis provided is slightly different in dimension. Chapter five provided a more detailed discussion on the impact of the regulations to Islamic banks and its ideals as well as the effectiveness of the level-playing regulations, whereas the current section provides the results on the impact of the regulatory accommodation based on the level-playing field regulations as well as the focus on treating Islamic banks on a level-playing field.

purchase the lower quality of assets whereas the conventional banks were not entitled to.

The examination of this research has also found that the capital certainty requirements provide a positive impact deriving from the level-playing field regulations. The analysis has found that while there is the question of conflicting with the profit-loss sharing principles (and Islamic banks have to make substantive compromise), nevertheless, this research has found that the regulatory accommodation leads to a level-playing field between Islamic banks and the conventional banks. Therefore, while the rudimentary principle of Islamic finance is based on profit-loss sharing contract where the latter represents a significant trademark of the Islamic financial sector, nevertheless, the dominating conventional financial system has a bigger influence over other financial forms of finance.

Pertaining to the negative impacts, there are five aspects, which have been extracted from the research analysis. These include: Sukuk, Sharia supervision, Home Purchase Plan, and the Deposit Guarantee Scheme.

For the regulatory treatment of Sukuk, in the case where the economic outcome of Sukuk is similar to the conventional bonds, no separate regulatory accommodation is provided by the UK regulators. It has been argued earlier that in the case where the regulators understand the Sukuk products fully and the matching conventional bonds, it can be assumed that there is no arising issues. However, there may be regulatory issues if the nature of a particular Sukuk is not understood fully or being misunderstood

by the regulators. Arguably, such regulatory issues would also arise in the case of new financial innovative products from the conventional financial sector.

Another negative impact to the existing level-playing field regulations is concerning the Home Purchase Plan regulations whereby the content of the regulations and the practice indicate a different contextual meaning. However, it has been argued in chapter three that the lack of clarity of the regulation could only affect the legal context but not the economic justification.

Finally, the level-playing field regulations on the Deposit Guarantee Scheme have led the UK Islamic banks to make substantive compromises which results to inequality at the substantive level. The implication of this is that the funds are intermingling with the conventional funds hence resulted to non-Sharia compliance investment and this has created a negative outcome from the level-playing field regulations. As a consequence, there is the non-Sharia compliance risk and reputational risks as Islamic banks are unable to implement the Islamic financial model.

Pertaining to Sharia supervision, as highlighted earlier, there is no specific regulatory accommodation on Sharia supervisory board or supervisor for Islamic banks. The element of formal equality shows that Islamic banks are free to place any Sharia supervisor which they prefer and this may possibly lead to a lack of product quality control and may also exposes Islamic banks to legal risk when there is no minimum requirement provided by the regulators. This can be evidenced from the Sharia-compliant disputes that were brought before the court of law. However, one may argue

that the absence regulations for Sharia supervision do not pose any impact to the question of level-playing field.

Furthermore, the analysis of this research has found that the English courts' treatment towards Islamic financial disputes results to a neutral impact relating to the context of treating Islamic banks on a level-playing field. There is no clear evidence to prove that the courts' treatment could result to a lack of level-playing field for Islamic banks. The element of the level-playing field regulations (in particular, the fair opportunity for Islamic banks to compete) cannot be seen to relate with the issue regarding the courts' treatment on the Islamic financial disputes. The evidence suggests that treating Islamic banking under the common law principles is not problematic since the court has the means to call expert witnesses on Sharia issues to testify the authenticity of the Sharia contract. Ultimately, the earlier paragraph have stated that the level-playing field regulations which do not provide specific regulatory requirement for Sharia Supervisory Board or a Sharia supervisor do not seem to provide any impact to the question of treating Islamic banks on a level-playing field.

We now move on the conclusive analysis on the Malaysian level-playing field regulations. This research has found that generally, the regulatory accommodation for Islamic banks is proven to be more positive than the UK in the sense that there are less substantive compromises to meet the formal equality requirement. One of the reasons could be that, as argued before, the Malaysian regulators took the proactive approach for the regulations of Islamic banks. Another reason that this research has inferred is the greater government's interest to establish Malaysian as the international hub for Islamic financial sector. This is not to mean that the UK's government has

lesser interest (in fact, the UK government has the same vision to be the international hub for Islamic finance), however, the reality is that the making of regulation is also influenced by several other factors such as the political-social-economical interest (this factor is discussed in chapter two (2.3.2 (v) of this research). This discussion in chapter two have also talked about the societal background of Malaysia which is dominated by Muslims, and the government's support on Islamic finance somehow reflects the encouragement for Modern Muslim society , and to pursue the Vision 2020 objectives. It has also been argued earlier that the greater support of the Malaysian government towards the Islamic financial sector is to represent the national identity. In chapter four, it has been highlighted that the Central Bank Act 2009 only indicates the obligation of the Central Bank of Malaysia to promote the Islamic financial services sector and does not impose such obligation for the conventional financial sector because there is an absence of such a provision indicating the same obligation for the CBM to promote the conventional financial services sector. As a result, it can be inferred that the conventional financial sector is rather disadvantaged.

The positive impact of the level-playing regulations in Malaysia is on the regulations pertaining to the authorisation of Islamic banks. The separate establishment for Islamic deposit insurance scheme has helped Islamic banks to invest the depositors' fund in a Sharia-compliant way. This research has argued that the separate Islamic deposit insurance scheme established under the Malaysian Deposit Insurance Corporation (MDIC) is seen to be a fairer system for Islamic banking sector and promotes transparency and market confidence to the depositors for the Sharia-compliant investment. This approach has been argued as a better approach than the UK system where it contained all of the elements for the level-playing field regulations (equality



before the law and fair opportunity for Islamic banks to compete). However, it was also opined that the separate Islamic deposit insurance scheme as in Malaysia is partly due to the bigger size of the Islamic banking market compared to the UK. Malaysia has more retail Islamic banks as opposed to the UK where it has only one fully fledged Islamic bank. Moreover, it can also be assumed that the UK regulators feels that there is no such need due to their clear statement on level-playing field regulations, which is 'no obstacles, but no special favours'.<sup>698</sup> Therefore, it may be unfeasible for the UK to implement such approach; however, it is not an impossible one. Nevertheless, there is no supporting data to show the reasoning behind the lack of interest of the UK regulators to establish a separate Islamic deposit guarantee scheme.

Another positive impact of the level-playing field regulations in Malaysia is the regulatory accommodation on taxation. Similar to the finding in the UK on the abolishment of double taxation, the regulatory accommodation is seen to create a fair opportunity for Islamic banks to compete with the conventional banks.

With regards to Sharia supervision, this research has found that the level-playing field regulations in Malaysia have created a positive impact to Islamic banks where there is the minimum requirement in terms of the eligibility criteria of a Sharia scholar and Sharia Supervisory Board (SSB). The implication to this is that Islamic banks could have better corporate governance as well as minimising operational risk and legal risk (in terms of product quality control). This resulted to a more positive impact arising from the dual-regulatory framework. However, as argued in the UK context earlier, the

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<sup>698</sup> Michael Ainley, Ali Mashayeki, Robert Hicks, Arshadur Rahman and Ali Ravalia, 'Islamic Finance in the UK: Regulation and Challenges', (2008),p.13

regulatory accommodation for Sharia supervision can also be said to produce a neutral impact to the question of treating Islamic banks on a level-playing field. This is because there is no direct link to the elements of level-playing field (equality before the law and the fair opportunity to compete).

Another neutral impact that could be inferred from the level-playing field regulations in Malaysia is in regards to the Islamic financial disputes. As discussed in chapter four, while there is the establishment of the National Sharia Advisory Council (NSAC) to decide on disputes on matters governing Islamic banks, the Malaysian courts seem reluctant to admit such empowerment given to the NSAC. While there is also Muamalat Division (Commercial Division) established in Malaysian court, however, it was highlighted that not all Malaysian courts has such specific division. As such, in most of the States in Malaysia, Islamic banking cases are brought before the commercial division (of a civil court) which is not specifically hear Islamic banking cases only, but also hear conventional banking cases. It was also highlighted in chapter four that there were lack of standardisation pertaining to the Islamic financial disputes as the Civil court judges prefer that their jurisdictional power is not interfered, and the English common law is a preferred approach. This research has also suggested that the establishment of the similar type of NSAC in the UK. Nonetheless, this research found that this issue resulted to a neutral impact to the question of level-playing field. This is because, there is no clear relevance to the elements of the level-playing field regulations (in particular, fair opportunity for Islamic banks to compete).

One negative impact that this research has found from the Malaysian level-playing field regulations is relating to the liquidity management regulation. As have been

analysed in chapter four, the separate regulatory accommodation for the Islamic inter-bank money market is in form has shown that it represents the level-playing field regulations. However, in substance, the conventional banks were allowed to invest in the Islamic Interbank Money Market hence the outcome of the whole investment in the IIMM may lead to a non-Sharia compliance risk, interest –rate risk as well as arbitrage risk. As a result of this shortcoming, the level-playing field regulations have not been enabled by the Malaysian regulators. This research has therefore found that the issue pertaining to the liquidity regulations in Malaysia and the UK is essentially different.

The discussion above is summarised in the table below where it highlights the general differences of the regulatory accommodation for retail Islamic banks in the UK and Malaysia, as well as the impact to the concept of level-playing field regulations.

#### **UNITED KINGDOM**

	<b>Unified<sup>*699</sup> Regulation/ Separate</b>	<b>Formal Equality</b>	<b>Substantive equality</b>	<b>Level-playing field</b>
<b>Authorisation</b>				
• <b>Collective Investment Scheme</b>	Unified	Partially	Yes	Partially useful
• <b>Home Purchase Plan</b>	Unified	Yes	Yes	Useful
• <b>Capital certainty requirement</b>	Unified	Yes	No	Useful
<b>Sharia Supervisory Board</b>	Unified	No	No	N/A
• <b>Competent requirement</b>				

<sup>699</sup> \* Unified = Islamic banks are regulated within the same regulation as the conventional banks

\* Separate = There are designated provisions for Islamic banks in some cases

• <b>Relevant experience</b>	Unified	No	No	N/A
<b>Islamic finance cases before the English courts</b>	Unified	Yes	Yes	N/A
<b>Regulatory decision making process</b>	Unified and separate	Yes	Yes	Useful
<b>Sharia – compliant liquid assets</b>	Unified and separate	Partially	Yes	Partially useful
<b>Taxation</b>				
• <b>Stamp duty land tax</b>	Unified and separate	Yes	Yes	Useful
• <b>Corporation tax</b>	Unified	Yes	Yes	Useful
• <b>Value-Added tax</b>	Unified	Yes	Yes	Useful

## **MALAYSIA**

	<b>Unified Regulation/ Separate Regulation</b>	<b>Formal Equality</b>	<b>Substantive equality</b>	<b>Level-playing field</b>
<b>Authorisation</b>				
• <b>Islamic Financial Services Act 2013</b>	Separate	Yes	Yes	Useful
• <b>Deposit Insurance Scheme</b>	Separate	Yes	Yes	Useful
<b>Sharia Supervisory Board</b>	Separate	Yes	Yes	N/A
• <b>Fit and Proper</b>				
• <b>Competent requirement</b>	Separate	Yes	Yes	N/A
<b>Islamic finance cases before the English courts</b>	Unified	Yes	Yes	N/A
<b>Sharia – compliant liquid assets</b>	Unified and Separate	Yes	Yes	Useful

<b>Taxation</b> • <b>Income tax</b>	Unified and separate	Yes	Yes	Useful
• <b>Real Property Gains Tax</b>	Unified and separate	Yes	Yes	Useful
• <b>Stamp duty land tax</b>	Unified and separate	Yes	Yes	Useful

Source: Author's own

Moving on further, the overall analysis of this research has found that there are several types of risks exposed to Islamic banks in the UK and Malaysia based on the level-playing field regulations. The table below provides the types of risk and country:

<b>Country</b>	<b>Type of Risk</b>
<b>The United Kingdom</b>	Transparency risk, operational risk, regulatory risk, reputational risk, liquidity risk
<b>Malaysia</b>	Interest-rate risk, arbitrage risk, reputational risk

Source: Author's own

These findings suggest that Islamic banks in Malaysia are exposed to less type of risks as compared to the UK. The implications of these results raise several assumptions. Firstly, it can be assumed that the dual regulatory framework helps Islamic banks to

face lesser risks. Secondly, the effect of these risks to the stability of Islamic banks is difficult to prove since there is no empirical evidence to prove it. The available data which shows the failure of the former Islamic Bank of Britain (IBB) did not cause contagion effect to the banking system. However, as argued in the earlier chapter, systemic risk may happen in the country where there is bigger presence of Islamic banks such as Malaysia. Furthermore, this research assumes that the risks affected to Islamic banks are still within control because thus far, there is no evidence to prove otherwise. Moreover, the issue of liquidity risk faced by Islamic banks in the UK has been resolved by the regulators through the Sharia-compliant liquid assets requirements.

In light of the arguments on whether Islamic banks should be given more regulation, the results of the analysis on the objectives of banking regulation suggests that simple regulation is desirable for Islamic banks. The analysis has been made in chapter two considering two perspectives of the arguments on more and simple regulations. The outcome of the analysis suggests that the existing level-playing field regulations do not seem to pose serious harm that could affect the stability of Islamic banks. Although Islamic banks are regulated within the conventional banking framework in the UK, there is no prove to show that Islamic banks are badly affected by the existing regulations. However, the stability of Islamic banks may be affected in the country where there is a bigger presence of the sector such as Malaysia. Additionally, the evidence has proved that Islamic banks are not listed as systemically important financial institution by the Financial Stability Board.

As have been highlighted earlier (chapter one - section 1.5.2, chapter two - section 2.5), an extended question to the two test questions (equality before the law and fair opportunity for Islamic banks to compete) is to be asking: when the level-playing field is seen to be distorted? In order to determine whether the playing field is level, the outcome of the level-playing field regulations must depict a positive outcome. If the level-playing field regulations are found to have a negative outcome, it must be an obvious negative outcome and not a mere negative outcome. An obvious negative outcome is argued as the outcome which affects the stability of Islamic banks and crisis emerged deriving from the regulatory treatment. A mere negative outcome involves negative effects which does not pose any major threat to the stability of Islamic banking sector. Therefore, this research suggests that more regulation for Islamic banks do not mean more regulation in terms of volume, but in terms of addressing risks which could affect the stability of Islamic banks, such as liquidity risk and operational risk. As such, the approach to simple regulation for Islamic banks is seen to be sufficient to accommodate the lack of regulation governing Islamic banks. This has therefore leads to the conclusion that is not necessary to have a dual regulatory framework merely to provide the level-playing field treatment for Islamic banks.

Level-playing field regulations can be said to be a positive approach in developing Islamic banks in the financial sector. Certain regulatory changes that were made by regulators to accommodate the unique features of Islamic finance have led to the rapid development of the Islamic banking sector within the last 30 years. Therefore, while on the one hand level-playing field regulations is a positive approach to develop this new sector, however, level-playing field regulations has its constraining nature. As

discussed earlier, the unique features of Islamic finance means that there are certain types of risks which are seen to be the same as the risks faced in conventional finance but differ in dimension. Furthermore, due to the level-playing field regulations and the different nature of Islamic finance, substantive compromises were needed to be made by Islamic banks in order to fit into the level-playing field regulations. This has led to the inequality at the substantive level and the level-playing field regulations ultimately posed challenges for Islamic banks to operate according to its unique features (the challenges have been discussed throughout this thesis), and potentially could impede the development of Islamic finance. While it is acceptable to have dual regulatory framework for Islamic banks like the Malaysian model, it can be suggested that the regulatory approach may not necessarily be confining to the idea of 'level-playing field'. This is because Islamic banks could not be fairly or equally placed in the same regulatory environment similar to the conventional banks for both of these sectors are operating on different principles. Islamic banks, therefore, can be better developed with the set of regulations which are tailored to its unique risks and features.

The impacts of the level-playing field regulations in the UK and Malaysia have indeed poses several implications to both jurisdictions. The positive impacts of level-playing field regulations have indeed resulted to regulatory certainty and clarity that could promote the development of Islamic financial sector. Moreover, a good regulation that produces positive impacts to Islamic banking sector could enhance liquidity in the financial sector domestically as well as internationally. Market confidence, regulatory transparency, and product attractiveness can be created with a sound regulatory accommodation that tailored to the specificity of Islamic finance. On the other hand, the negative impacts to the level-playing field regulations have produced lack of



regulatory clarity and uncertainty in both countries' regulatory framework. As mentioned throughout this thesis, the lack of regulatory clarity and uncertainty could therefore produce several types of risks to Islamic banks and ultimately, causing the lack of confidence in the Islamic banking sector. This could not only affect the liquidity market of the Islamic banking sector but also impede its development. Lesser interests for Islamic banking investments may happen and reputational risks may be caused due to the absence of regulation for Islamic banks. Whereas the neutral impacts which derive from the level-playing field regulations, arguably, could not affect the liquidity market for both jurisdictions. It can also be argued that the impacts of the level-playing field regulations could produce similar impacts to other jurisdictions. Notably, based on the research findings, it can be inferred that in reality, the regulatory accommodation for Islamic banks regardless of the regulatory architecture (either unitary regulatory framework or dual regulatory framework) is irrelevant. What is important for the Islamic banking sector is the availability of regulation that could accommodate the specificity of Islamic financial principles and risks exposed to Islamic banks. Possibly, the approach to soft-law such as guidelines, core principles or codes of conduct which could serve the need of the Islamic banking sector is a better mechanism to be adopted.<sup>700</sup>

One of the most notable implications of the level-playing field regulations against the regulatory frameworks of both jurisdictions, as argued earlier, is derived from a particular causality arising from the public policy and institutional frameworks of each country. As has been discussed in chapters two and three, the UK's level-playing field

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<sup>700</sup> Aldohni, 'Soft law, Self-regulation and Cultural Sensitivity: The case of regulating Islamic banks in the UK', (2014), p.167

regulations for all the financial institutions is the 'no special favours' among the banking and financial institutions which is embedded in its regulatory policy. As such, a particular regulatory accommodation is only given based on the need of regulating the product as well as the potential of having positive outcome from such accommodation. In this regards, chapter two and three have shown that while the UK government strongly supports the development of the Islamic banking sector, the regulatory policy in the UK is mainly based on the idea that the benefits of regulation should outweigh the cost - for instance, the regulatory accommodation on abolishing the double taxation for Islamic financial mortgages, the regulation for certain classes of Sukuk and the recent liquid asset regulation for Islamic banks. As such, another causality that can be linked to the existing level-playing field regulations in the UK is that the spirit of regulating the Islamic banking sector is mainly for the purpose of enriching the liquidity in the market – not necessarily to support the Islamic financial principles and its features *per se*. Therefore, it is inferred that the religious aspect or Sharia-compliant aspect of the product or the institution is left to the bank to manage it.

Furthermore, the regulatory development in the level-playing field regulations represents that the regulatory accommodation for Islamic banks covers only on certain aspect while ignoring other aspects which could affect the operations of Islamic banks. The regulated aspect is, however, only given to the regulators' attention when it is brought forward by the market players and Islamic bankers. And the initiative to develop a particular regulatory accommodation is heavily based upon the 'voice' of the sector rather than the initiative taken by the regulators to promote the regulatory development for Islamic banks (this is somewhat contrary to the Malaysian environment). As such, it can be inferred that the regulatory development of the level-

playing field regulations in the UK is mainly based on the real need of regulating the sector than merely regulating without justification. Moreover, chapter three has highlighted that the objective of the UK is to become the leading Islamic financial gateway in the Western world. Therefore, it can be inferred that the regulatory strategy in the UK's level-playing field regulations is towards reaching its objective as a competitive Islamic financial market in the world.

On the contrary, in Malaysia, the stronger support of the government and policy makers represent the establishment of vast regulatory framework for the Islamic banking sector. The dual regulatory framework representing the idea of treating Islamic banks on a level-playing field with the conventional banks shows that almost every aspect of Islamic banking is regulated. From the analysis of this research, it can be inferred that the stronger political will as well as the national's agenda to make Malaysia as the hub for Islamic finance in the world motivates the government and policy makers to work towards achieving this objective. Therefore, it can be argued that as opposed to the UK's policy, the level-playing field regulations in Malaysia is systematically developed - without necessarily focusing on the cost and benefit of a particular regulatory accommodation for the Islamic banking sector.

Moreover, the Malaysian government and regulators are seen to be more motivated and proactive to regulate the sector throughout the years as opposed to the UK's environment. Arguably, there is a deeper 'faith' on the part of the Malaysian government and policy makers towards Islamic finance. As such, there is little need for the Islamic financial market players to propose for the level-playing field regulations in contrast to the UK. As a result of the vast level-playing field regulations, Islamic

banking sector in Malaysia is often referred to be the better regulatory model for the sector's development. While it is agreeable that a particular regulatory framework or architecture for each country could not be totally followed by another country, however, the dual regulatory framework in Malaysia is found to have caused lesser substantive compromises on the part of Islamic banks. A better development and sustainability of the sector from such regulatory approach can be seen where Islamic banking sector's growth in Malaysia is stable, unlike in the UK where a number of Islamic banking windows has stopped its operations. As such, the lack of regulations for Islamic banks in the UK affects the sustainability of Islamic banks.

It is also apparent that establishing a separate regulatory framework for Islamic finance could enable a bigger market confidence and market presence, such as in Malaysia. However, one criticism regarding the dual regulatory framework is that while the level-playing field regulations resulted to the creation of two separate legislations, the Islamic Financial Services Act 2013 contained mostly similar provisions with the Financial Services Act 2013 thus question the need of having the separated regulations. Therefore, it can be argued that an important factor for a good Islamic banking regulation is to have a comprehensive set of regulations that provides more clarity and transparency, as well as regulations which are created to address the nature and risks exposed to Islamic banks. However, the existing challenge is to harmonise the conventional financial system with the Islamic financial system. While these two systems are operating side by side, nevertheless, they do not exist in harmonious way. Finally, the cross-cultural sensitivity<sup>701</sup> is also the inherent factor that

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<sup>701</sup> Supra, Note 700.

has its influence to the policy making of the Islamic banking sector which resulted to the degree of regulatory accommodation for Islamic banks in a particular country. Therefore, by taking into consideration the factors that influence the regulatory policy and institutional policy for Islamic banks, the establishment of the level-playing regulations in the UK and Malaysia can be said to be appropriate in its own right.

### **6.3 RESEARCH LIMITATIONS**

A number of caveats need to be noted regarding the present research.

Firstly, this research does not cover all aspects within retail Islamic banks. The analyses made in this research are some examples that are viewed as relevant within the context of level-playing field regulations. In this research, not all aspects between the retail Islamic banks and the conventional banks are shown. This is for the fact that the research context of level-playing field regulations gave the emphasis on the part of Islamic banks, and it is outside the scope of this research to analyse on the level-playing field regulations on the conventional banking context. Additionally, this research is limited by the lack of available information on retail Islamic banks.

Secondly, chapter one (section 1.5.1) has discussed on the limits of comparative law methodology. It was highlighted that there are disadvantages of using this method. These are: the regulatory approach of both countries differs, as well as the variations of political, social, history, and economic interest between both countries. There is also no standard methodology for comparative lawyer to adopt. Moreover, as have been argued in chapter one, the task to determine a meaningful comparison is harder and the clear cut answers in a comparative legal research has been argued as

somewhat rare. Therefore, the factors above has therefore led to the third limitation whereby this research is unable to suggest which regulatory framework is more suitable to adopt the level-playing regulations – either within the single or dual regulatory framework. However, what can be suggested by this research is that it is not necessary to adopt a dual regulatory framework to create the level-playing field regulations for Islamic banks.

Fourthly, another important limitation of this research is that the reference to Islamic bank in the UK is concentrated on one bank, which is Al Rayan Bank (formerly known as the Islamic Bank of Britain). This is because, Al Rayan Bank is the only fully fledged Islamic bank in the UK, and the available data is viewed to be consistent and reliable.

Fifthly, the current research was not specifically designed to evaluate two other areas. One, this research was not intended to discuss the detailed aspect of the political-social-economic factor of both countries for the fact that the main focus of this research is pertaining to the level-playing field regulations. Two, the current research was not intended to provide a detailed analysis on the context of legal transplant or legal pluralism which can also be argued to influence the existing legal accommodation for Islamic banks in the UK and Malaysia. While both of these factors can be argued to be one of the influencing factors for the legal culture of both countries, however, it is felt that these factors require a separate research of its own nature.

Next, chapter three has briefly mentioned that the UK regulations are also subjected to the European Union Directives. This research does not discuss the regulations

under the European Union Directives. This is because the focus of this research is mainly focusing on the UK's domestic regulations.

Finally, one major limitation in this research is the limitation of available resources on the meaning of level-playing field. It has been difficult for this research to find any available data which provide an in-depth research on the idea of level-playing field. On top of that, the fact that there is no previous study on the level-playing field regulations (especially on Islamic banks), this has ultimately limit the arguments in the current research.

#### **6.4 FUTURE RESEARCH RECOMMENDATIONS**

A number of possible future studies using the same test questions of level-playing regulations would be interesting.

Firstly, the fact that this research is literature-based, it would be worthwhile to conduct further research on the level-playing field regulations of Islamic banks by conducting a cross-field study involving economic study and law. The cross-field study could produce interesting findings by using economic variables and possibly, combining the comparative law methodology. Other possible cross-field study for future research would be to investigate why the level-playing field regulations are treated in varied way by different jurisdictions through political – economy discipline. It can be suggested that the two cross-filed studies could provide more information on why the level-playing field regulations for Islamic banks is structured as it is. In particular, how the political-economy of a country influence the level-playing field regulations for Islamic banks. In

addition, the same methodology and concept of this research can be used to conduct future research between other jurisdictions.

Future research should assess the impact of level-playing field regulations in other areas within the Islamic banking sector. As this research was focusing on retail Islamic banks, further research should therefore concentrate on the investigation of wholesale Islamic banks. Other focus areas could be the investigation of the level-playing field regulations between the Islamic insurance (Takaful) and the conventional insurance, the Islamic securities and the conventional securities. Additionally, future research can be conducted on other sector such as the level-playing field for the conventional banks.

Thirdly, due to the fact the analyses of this research was conducted by a limited review of the literature, more information on the effect of the level-playing field regulations towards the stability of Islamic banks would help us to establish a greater degree of accuracy on this matter.

Finally, the two test questions of level-playing field regulations are not exhaustive. Future studies investigating other potential test question to determine what constitute as level-playing field regulations would be very interesting.

## **6.5 FINAL REMARKS**

This research has demonstrated the extent of the level-playing field regulations on Islamic banks in the UK and Malaysia. This is the first research that has established two test questions to be used to analyse the level-playing field regulations for Islamic



banks as well as incorporating the comparative law methodology. It is viewed that in spite of the existing caveats which has been mentioned earlier in this chapter, in general, the main objectives of this research has been achieved.

Two major significant findings to emerge from this research are that the regulators have not enabled the level-playing field regulations in totality for Islamic banks, and the level-playing field regulations are found to be a useless concept.

For the first major finding, the regulators have not enabled the level-playing field regulations. The test questions used in this research has shown that there have been substantive compromises on the part of Islamic banks to serve the element of formal equality. As a result, the substantive compromises which have been described earlier leads to a lack of equality at the substantive level. In some areas of the regulatory accommodation, there is the lack of opportunity for Islamic banks to compete fairly with the conventional banks. Despite this finding, chapter one (Section 1.5.2) and chapter 2 (Section 2.3) have argued that it is not necessary to always have equality at the substantive level to exist. In other words, formal equality can somewhat help Islamic banks to have a fair opportunity to compete with the conventional banks, such as the capital certainty requirements and deposit insurance scheme - although Islamic banks has made compromises at the substantive level.

Therefore, this research has argued that while it is desirable that substantive equality exists in most instances, nevertheless, the absence of equality at the substantive level does not necessarily render the existing law as invalid law. It can be argued that an invalid law is only when the outcome of the law depicts an obvious negative outcome,

and not a mere one. This research argues that an invalid law with respect to the Islamic banking context is when the law could pose serious harm to Islamic banks in terms of its stability. Since there is no empirical evidence to proof that Islamic banks are suffering from instability, for instance, pertaining to the capital certainty requirements, the lack compromises at the substantive level could not regard the law as invalid.

The second major finding was that the level-playing field regulations are found to be a useless concept. While in some aspect of the regulatory accommodation have proven that there is the effective level-playing field regulations, nevertheless, from a larger perspective, the idea of level-playing field regulations is not an ideal approach to regulate Islamic banks within the complex financial environment. As have been argued in Chapter two, the notion of level-playing field is nothing more than a metaphorical term to standardise the uncertainties, complexities and diversity in the financial system. It can be said that the regulators have not been able to reconcile the level-playing field regulations within the existing financial system. Moreover, the criteria of equality, fairness, justice in regulation are difficult to be interpreted in certain form and cannot be equalised. Chapter two and chapter five have presented the realities and challenges that have resulted to the problems of enabling the level-playing field regulations. Thus, level-playing field regulations which is seen as the benchmark to equalise the uncertainties and diversity that exists in the financial system is not a workable concept.

Moreover, to have the absolute level-playing field regulations is nothing more than a wishful thinking. The fact that financial system constantly evolved, the latest financial innovations has made the concept of level-playing field regulations more difficult to be

enabled. And regulations, too, is not meant to be static. Following Jeremy Bentham's argument, law is temporary by nature and by institutions. Law is said to have "its duration and upon which it may be contracted to any length by the express will of the legislator."<sup>702</sup> This statement indicates that the law is temporary based on the legislator (or regulators) intention to have the law as long as it is believed to be relevant at the point of time. Once the law is believed as no more relevant at a particular time, the law will be changed according to the suitability of the current situation. Applying Bentham's argument in the case of banking law, it can be argued that the banking law will evolve from time to time to accommodate the changes in the financial system. It is, therefore, difficult to imagine that the level-playing field regulations can successfully be enabled to accommodate the diversity and complexity in the financial system. Furthermore, it can be said the creation of regulations is not only to prevent harmful conduct, but it is also created to prevent harmful consequences and harmful risk. It can be argued that the creation of regulations do not rely solely on the risks attached to Islamic banks, but also other factors which influence the making of regulations such as economic issues and political-cultural issues.

Finally, since this research has found that the level-playing field regulations for Islamic banks have not been fully enabled in both countries, this research suggests that the regulators should only provide appropriate regulations for Islamic banks. However, the term appropriate regulations are subjective and it is not an easy task to determine whether the objective to provide appropriate regulations has been achieved. The term 'appropriate' as defined in the Oxford's Dictionary refers to "something suitable,

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<sup>702</sup> H.L.A Hart (ed), *Of Laws in General: Collected Works of Jeremy Bentham*, (1970), p.74

acceptable, or correct for the particular circumstances.”<sup>703</sup> By definition, the term is still vague and quite problematic. This has raises an issue as to how could we regard something as appropriate or inappropriate, acceptable or unacceptable? It has been argued by Goodhart that, so far, there is no authoritative attempt to present any quantitative or qualitative information to present the ‘appropriate’ criteria for a regulation.<sup>704</sup> He suggests that three economic objectives which can be referred by regulators when enacting regulation. Firstly, the regulator’s objective for regulation is to prevent a systemic failure of financial institutions, and/or financial markets. Secondly, to prevent competitive losses and thirdly, to provide consumer protection (i.e. to prevent ill-informed (retail) customers from being exploited).<sup>705</sup> He goes on to argue that what can be regarded as appropriate regulations is left in the hands of the regulators. This research supports his view and would like to extend the opinion that another party who could decide whether the regulations are appropriate is the sector that is regulated. In regards to this research, it is the Islamic banking sector.

This research suggests that to have appropriate regulations for Islamic banks, the reasonable approach to deal with this issue is to have the regulators to incorporate or imposed the established international regulatory standards for Islamic banks form the International Financial Services Board (IFSB) and the Accounting and Auditing

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<sup>703</sup> Oxford Advanced Learners Dictionary (2000)

<sup>704</sup> Charles E. Goodhart, ‘Regulating the Regulator – An Economist’s Perspective’ in Eilís Ferran and Charles E. Goodhart (eds), *Regulating Financial Services and Markets in the Twenty First Century*, (2002), p.152

<sup>705</sup> Ibid., p.152-154. Goodhart asserts, “...Unless such external criteria are presented, and in such form as they are capable of measurement and assessment, then it seems that judgment about what was ‘appropriate’ is left entirely in the hands of the FSA. The FSA will, therefore, be its own judge about whether it has acted appropriately in the light of this objective. Most judges rule in their own favour.”

Organization for Islamic Financial Institutions (AAOIFI) in their existing regulatory framework. Based on the analysis made in this research, another additional suggestion to improve the regulation for Islamic banks is pertaining to the liquidity management of Islamic banks.

In terms of having the best outcome for the regulations of Islamic banks, what should be expected is the readiness of the regulators to develop the regulations to promote the competitive nature of the banking sector. However, the burden is still left to the Islamic financial sector to lobby for the issues that they encountered to the regulators in order to receive the most appropriate regulations for the sector to develop.

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